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Deloitte &
Touche

Ad Hoc Advice to the Ministry of the Economy of Slovakia

Advisor's Final Report

Delivery Order No. 15
Project No. 180-0014
Contract No. EUR-0014-I-00-1056-00
Eastern Europe Enterprise Restructuring and Privatization Project

U.S. Agency for International Development
EUR/RME

June 1993

Deloitte Touche
Tohmatsu
International

Deloitte & Touche

Suite 350N
1001 Pennsylvania Avenue, N.W.
Washington, D.C. 20004-2594

Telephone: (202) 879-5600
Facsimile: (202) 879-5309

June 8, 1993

Mark Karns
EUR/RME
U.S. Agency for International Development
320 21st Street, N.W., Room 6923 N.S.
Washington, DC 20523

Re: **Contract No. EUR-0014-I-00-1056-00, Deliverable for Delivery Order No. 15, Ad Hoc Advice to the Slovak Republic**

Dear Mr. Karns:

In accordance with Article IV of the referenced delivery order, enclosed please find four copies of the deliverable entitled "Ad Hoc Advice to Ministry of Economy of Slovakia, Advisor's Final Report."

This deliverable was prepared by the Deloitte & Touche team working in Bratislava, Slovakia. If you have any questions concerning this deliverable, please call Lynne Damon at (202) 879-5386. Thank you.

Sincerely,

Kathleen J. Machen

Kathleen J. Machen
Operations Manager

Enclosure

ACKNOWLEDGEMENTS

During the period from December 1992 to May 1993, I had the opportunity to spend nearly five months working as an advisor to the Ministry of Economy. I would like to express my gratitude to the Ministry of Economy, the Agency for International Development, and Deloitte & Touche for the chance to work as an advisor during a particulary interesting time in Slovakia's history, the most noteworthy event of which was its becoming an independent country on January 1, 1993.

First, I would like to gratefully acknowledge the hospitality and assistance of the Ministry of Economy, which supplied an office, support, and a cordial working atmosphere during the period of this advisory assignment.

Special thanks are owed to former Minister Ludovit Cernak, and the current Minister, Ing. Jaroslav Kubecka. I would also like to acknowledge the cooperation and support of Mr. Milos Lelovsky, Mr. Jozef Petras, Mr. Marian Jezek, Mrs. Sajtlovova, Mrs. Anna Nemethyova, Mrs. Viera Jureckova, Ms. Jana Karelova, Mrs. Chambalova, Mr. Misik, Ms. Eva Vanurova, Mrs. Mathe, Mrs. Bozena Rolkova, Ms. Adriana Szalayova, Mrs. Antonia Brezovanova, Mrs. Silvia Hrinova, Mrs. Lubica Dobsovicova, Mrs. Dubekova, and Mrs. Daubnerova.

I would also like to thank USAID/Bratislava, and especially the USAID Representative to Slovakia, Patricia Lerner. Members of her staff, especially Deborah Crane and Marian Krsko were also quite helpful. The US advisory and consulting community was a valuable source of information and insight, especially US Treasury consultant Irving Sirkin, who was also on assignment to the Ministry of Economy, and who organized a well-received seminar series on market economics.

Special thanks are also owned to the staff of Deloitte & Touche/Bratislava, especially Robert Wood, Mel Mraz, Steve Hudak, Amy Hudak, Pavol Lancaric, Lubo Halushka and Dagmar Kanyova.

Working under sub-contract with Deloitte & Touche enabled me to benefit from and draw upon an impressive array of Deloitte & Touche personnel and resources from, inter alia, Bratislava, London and Prague, in the areas of auditing, accounting, financial analysis, valuations, management consulting, privatization, corporate finance, investment banking, as well as sector specific expertise. Appreciation is also expressed for Deloitte & Touche's International Lending Agency (ILA) group in Washington D.C, and especially Art Warman, Gus Vega, Anne Nissenson, and Kathy Machen.

Michael P. McLindon
May 19, 1993

MINISTRY OF ECONOMY
OF THE SLOVAK REPUBLIC

Jaroslav Kubečka
minister

Bratislava May 14th, 1993

Dear Mr. McLindon,

I would like to thank you and Deloitte and Touche for all your help to the Ministry of Economy during your time in Slovakia.

Your work on industrial policy, privatization, foreign investment and trade, and secondary insolvency has been extremely timely and useful for us. My staff and I have enjoyed working with you very much.

I wish you all the best, and hope that you will return to Slovakia soon to work with us again.

Sincerely,

Mr.
Michael McLindon
adviser
Ministry of economy of the SR

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ADVISOR'S FINAL REPORT

Introduction and Summary

PROJECT NAME: Ad-Hoc Advisor (Delivery Order No. 15)

PROJECT MANAGER IN SLOVAKIA: Deloitte & Touche

ADVISOR: Michael P. McLindon

PERIOD OF WORK COVERED BY ADVISOR: December 4-22, 1992, and January 11 - May 19, 1993.

Summary of Major Accomplishments

- Completion of work on industrial policy paper, which was accepted by Slovakia's Economic Council in late February.
- Completion of reports and memos on infrastructure privatization, a privatization unit for chemical sector, foreign direct investment, trade policy, and inter-enterprise arrears as requested by Minister and MOE staff.
- On-going advice to Minister and staff at Ministry on privatization, foreign investment, exchange rate policy, inter-enterprise arrears, foreign trade, and related areas.
- At request of Ministry, ongoing briefings on the economy to teams from USAID, the World Bank, IFC, EBRD, Know-How Fund, EC Phare.
- Delivery of seminars and presentations to Ministry staff and others

Previous Reports Prepared by Advisor.

- "Inception Report," December 23, 1992 for USAID and Deloitte and Touche.
- Report Covering the period January 11 - February 28, 1993, for USAID/W and Deloitte and Touche.
- Quarterly Report covering period January 11 - March 31, 1993, for USAID/Bratislava.
- Various specific reports and seminar presentations prepared for Ministry.

These previous reports are incorporated in this final report.

Background.

The Ministry of Economy. The advisor arrived in Bratislava on December 4, 1992, to work as an ad-hoc advisor to the Ministry of Economy. The Ministry of Economy is one of the senior ministries in Slovakia. In 1992, several previously independent ministries were merged into the Ministry of Economy, which helps to explain its present size and large portfolio of activities and responsibilities. The MOE is the "founding" ministry for industrial and commercial enterprises in 19 different sectors, including the energy sector.

The MOE has 419 state owned enterprises in its portfolio (and an additional 80 that are in the process of liquidation), for which it is responsible for preparing privatization plans in collaboration with the management of the enterprises. These plans are then presented to the Ministry of Privatization for approval to proceed. The Ministry of Economy is also responsible for industrial policy, trade policy and relations, and plays a leading role in foreign direct investment.

Strategy and Modus Operandi. The advisor's scope of work was to provide on- going economic and financial advice to the Minister of Economy and his staff. It was anticipated that the assignment would call on the advisor to provide advice and information on a fairly wide range of topics that were within the Ministry's sphere of responsibility, including industrial policy, privatization, trade, and direct foreign investment.

Thus, it was envisioned that the ad-hoc advisory work would take a fairly wide-ranging "shotgun" approach in the above mentioned fields. This was related in part to the fact that as of January 1, 1993, the Slovak Ministry of Economy would be carrying out its duties for the first time as a part of the newly independent country of Slovakia. This followed from the decision of the Czech Republic and Slovakia to end the federation which has existed after the "Velvet Revolution" of 1989.

Further, it was anticipated--correctly, as events transpired--that the Ministry would be in a position to avail itself of assistance on a number of policy fronts for which it had primary responsibility. Thus, outside advisory assistance would be of use in addressing the basic policy issues in the fields of privatization, foreign investment, trade and other areas.

This approach was underscored by the fact that many of the foreign lending agencies and donors in addition to USAID, such as the World Bank, the IMF, the EBRD, the IFC and others, would be making their first visits to the newly independent country of Slovakia, at which time some initial policy dialogue would take place.

In turn it was anticipated that this "shot-gun" approach would help the Ministry--and USAID, which is further developing and refining its program and strategy for assistance--to help identify more specific targets of opportunity which would lend themselves further down the road to a more focused "rifle" approach. Indeed, such specific areas of opportunity are identified briefly below for the consideration of the Ministry and USAID.

As a part of the ad hoc advisory services provided under Delivery Order No. 15, a series of meetings were held with the Minister and key heads of department during the first two weeks in order to gain a better understanding of the Ministry's work, and the challenges facing it.

Several requests for advisory assistance were identified by the Minister and the Ministry staff. In some cases this involved, in addition to meetings and consultations, the preparation of reports and memos. The advisor was also able to draw on previous work and experience in areas of interest to the Ministry and, with appropriate modification, present it to the Ministry in a fairly short period of time.

For example, privatization techniques and strategies were a frequent topic of discussions and meetings. Standardized privatizations (tenders, initial public offerings, etc.) now assume greater significance in part as a result of the Slovak government's dissatisfaction with coupon privatization which had been implemented in 1992 when Slovakia was still a part of the Federation of the Czech and Slovak Republics.

The advisor had written a working paper on privatization strategies and techniques (and their relationship to capital market development) shortly before undertaking the engagement in Slovakia. As this paper, and the experiences underlying some of the ideas and conclusions, formed the basis for much of the discussions in the Ministry on privatization (as well as a three hour seminar delivered by the advisor on this topic in April), the paper is included for the reader's ease of reference.

Industrial Policy. During the first two weeks in Slovakia, the Minister of Economy requested the advisor in December 1992 to assist in the further development of the Ministry's paper on industrial policy. This was completed by the advisor as an "inception report" on December 23, 1992.

After reviewing a draft document, it was recommended that the government adopt an "enabling" rather than an "interventionist" approach to industrial policy. The recommended specific elements of industrial policy included continued privatization as a primary instrument of restructuring, promotion of foreign investment, an export orientation in trade policy, the development of capital markets, and facilitation of the private provision of economic infrastructure.

After departing from Bratislava on December 23, 1992, the advisor returned on January 11, 1993. (The original period of work was for sixty days. This was extended twice at the request of the Ministry of Economy to May 20, for a total of 130 days.)

Objectives for Early 1993. Discussions in mid January with the Minister indicated that the further practical development of these elements of industrial policy within the MOE would be particularly useful.

Within this fairly broad scope of activities, there were three objectives agreed to with the Minister: (1) Work with the Ministry to complete the industrial policy paper and secure approval by the Economics Council. (2) As requested by the Minister in January, work with the Ministry's foreign investment and trade units on policy and implementation. (3) Continue to provide ad-hoc advice in the areas of overall economic policy, privatization, infrastructure, trade and related areas.

Changes within the Ministry. In mid-March 1993, the Minister of Economy, Minister Ludovit Cernak announced his resignation.

During his time in office, Minister Cernak was very supportive of the ad hoc advisory work, and the advisor enjoyed excellent access to the Minister and the MOE staff. Minister Cernak provided the advisor with an office near his in the Ministerial cabinet, and would drop by several times a week for discussions. Minister Cernak also invited the advisor to sit in a meetings (e.g. with managers of SOEs, trade unions, the IMF) to give a flavor to some of the workings of political economy.

While some of the momentum generated by the advisory assignment was inevitably slowed a little during the three week transition period, and ensuing reorganization and change of some key staff members at the MOE, almost all of the initiatives have carried over under the new leadership.

Mr. Cernak's replacement is Mr. Jaroslav Kubecka. A meeting with Minister Kubecka confirmed his interest in and support for the ad hoc advisory work.

Minister Kubecka requested that, in addition to continuing with ongoing undertakings, the advisor spend some time on the problem of inter-enterprise arrears during late April and early May, which the Minister views as one of the most serious issue facing the MOE and the Slovak economy. This period of the ad-hoc advisory work coincided with the arrival of the World Bank team to prepare an economic memorandum which would establish the basis for its program, and a request by the MOE to accompany the World Bank team on its mission to Kosice, Detva and Ziar nad Hronom.

Activities and Outputs.

Industrial Policy

--Preparation in December 1992 of report analyzing the Ministry's industrial policy paper, with suggestions on how to modify and strengthen it.

--Follow-up discussions on industrial policy paper with staff at Ministry of Economy in January 1993. Meetings with Mr. Kosir (Center for Strategic Studies) and Mr. Kozlik (Prime Minister's Office) on role of industrial policy in overall economic policy. Industrial policy paper approved by Economics Council in late February.

Privatization

--Drafted paper at Minister's request on private sector approaches (BOO/BOT) to infrastructure development, based on advisor's previous experience in this area. (Infrastructure was identified as a key component of the MOE's industrial policy.)

--Ongoing discussions with Mr. Jezek, Vice-Minister and head of the chemical division in the Ministry of Economy; reviewed privatization plans for chemical industry. Arranged for a presentation on approaches and strategies for privatization of chemical industry, and the development of a privatization technical unit.

--Discussions with energy division of MOE on privatization approaches; provided documents on private sector approaches to the power sector.

--Discussion with director of tourism in the Ministry of Economy on privatization and promotion for tourism sector

--Discussion with MOE's head of privatization department, which is responsible to reviewing and finalizing the privatization plans of SOEs.

--Meetings with Minister of Privatization, and Fund of National Property, to review progress and discuss future plans.

Foreign Investment and Trade

--Briefings with Minister Cernak on advantages of devaluation, and means of promoting foreign direct investment.

--Worked with foreign investment unit of MOE. Provided information on corporate income taxation and foreign direct investment in

Central and Eastern Europe. Meetings with IFC and FIAS; developed with unit a request for a diagnostic study with this unit. Discussions and draft of policy points on foreign investment. Meetings with head of American-Slovak Fund on impediments to foreign investment and business development. Briefing for newly arrived advisor to SNAFID (Slovakia's foreign investment promotion agency) on the economy, and prospects for foreign investment.

--The request for an IFC-FIAS diagnostic study was responded to affirmatively by the IFC, and led to a mission in late April. Advisor briefed IFC-FIAS official and helped to identify key contacts to further assignment.

--Discussion with USAID sponsored environmental advisors on private sector approaches to environmental management, and on status of limitations on environmental liability for pre-existing problems, as a means to encourage foreign direct investment in certain sectors, especially the chemical sector.

--Memo to Minister with recommendations for approaches to trade policy.

Foreign Donors and Lending Agencies

--At request of Minister and staff, provided briefings on the economy and privatization efforts to teams from USAID, the World Bank, International Finance Corporation, the European Bank for Reconstruction and Development, and U.K. officials representing the British Know How Fund, EC Phare and the Bank of England.

--Attended meeting chaired by Minister Cernak with representatives from the World Bank. Discussion of types of assistance the World Bank can offer, importance of upcoming negotiations with the IMF.

--Attended meeting chaired by Minister Cernak with representatives from the IMF. Discussion of agenda with respect to a standby agreement.

--Briefing on economic setting and energy policy with Len Rogers and team, and later Robert Ichord, USAID/Europe.

--Briefing on privatization and MOE activities for David Dod, AID chief economist for Europe.

--Initial identification of several projects for Minister Cernak for discussion with donors and lending agencies.

--Briefed World Bank mission, which was writing economic memorandum on Slovakia. At request of Ministry of Economy, accompanied World Bank on field trip in late April to Kosice to visit VSS and VZS, to Detva to interview an SOE in the process of military conversion, and to Ziar nad Hronom to visit the aluminum company.

Inter-enterprise Arrears

--Meetings with Mr. Petras, head of finance division in Ministry of Economy, on problem of inter-enterprise arrears. Drafted scope of work to deal with problem. Meeting with World Bank representative to coordinate scope of work with possible World Bank sectoral loan to address problem of inter-enterprise arrears. Review of MOE data on MOE and FNP enterprises. Drafted memo on inter-enterprise arrears.

General

--Meetings with Slovak officials and members of advisory community that could provide information relevant to industrial policy, and components of industrial policy--privatization, infrastructure development, foreign investment, export promotion, and capital markets.

--Review of relevant Slovak, USAID, World Bank, IMF, IFC and EBRD documents pertaining to Slovakia.

--Follow up on request for information on technology and R&D policy from MOE's technical unit.

--Discussions with Dr. Kosir of Center for Strategic Studies on economic modelling, and provision of a paper previously written by advisor on this topic.

Background Papers and Reports Prepared for/Presented to Ministry:

- "Inception Report: Review of MOE's Industrial Policy Paper"
- "Private Sector Infrastructure Development: The Potential for BOO/BOT in Slovakia"
- "A Technical Unit for Standard Privatization for the Ministry of Economy."
- "Direct Foreign Investment (DFI): The Main Policy Issues"
- "Trade Policy for Slovakia"
- Memo on Inter-Enterprise Arreas
- Terms of Reference for an Analysis of Inter-Enterprise Arrears in Slovakia.
- "Military Expenditures in Models of Economic Growth"
- "Securities Markets and Privatization"

Seminars and Presentations

- "Sources of Finance for Slovak Enterprises" for the staff of the Ministry of Economy, as part of the MOE seminar series organized by US Treasury Advisor, Irving Sirken. (Three hour seminar, March 11, 1993)
- "Privatization and Capital Market Development" for the staff of the Ministry of Economy. (Three hour seminar, April 8, 1993.)
- Presentation at USAID monthly meeting on BOO/BOT approach to infrastructure privatization. (February 2, 1993.)
- Presentation to Vahostav in Zilina, a large private sector Slovak construction company, on BOO/BOT infrastructure privatization. (February 18, 1993)

Recommendations to USAID

As this report discusses, the following areas are offered for consideration by USAID and the Ministry of Economy for possible USAID support:

- Inter-Enterprise Arrears, or "secondary insolvency." This was the subject of the terms of reference which were drafted in March. The TOR is currently under review between USAID and the Ministry of Economy.

  During the next few months, the MOE and the Government of Slovakia will be reviewing a number of different proposals to deal with the problem of inter-enterprise arrears.

  Additional analysis is required to ascertain the current situation of enterprises. It would be helpful to have technical assistance to work with the MOE and related ministries and agencies to try to identify the approach that is most consistent with long run economic stabilization and growth. The danger exists that subsidies or credit facilities may be presented as "rescue operations" for illiquid enterprises which in essence would reintroduce the soft budget constraints, with potentially disastrous implications for overall fiscal and monetary policy.

  The aim of any rescue operation should be guided to privatization and restructuring. Since the current emphasis of the government of Slovakia is on standard privatization, the technical assistance could use the data and information gathered to help the Ministry of Economy to develop a strategy for proceeding with the privatization of the remaining 419 MOE enterprises. As such, this activity would be complementary to the following:

- Technical Unit for Privatization. This would make resources available to the Ministry of Economy to assist in the identification of candidates for privatization, in analyzing the options available, and in structuring the privatization. This would be particularly useful if the Government of Slovakia decides to continue to make standard privatizations rather the coupon privatization the main emphasis in its privatization program. For details on the objectives and activities of this unit, please refer to the paper on this subject contained in this report.

- Trade Promotion. Experience in other countries has demonstrated that there is a high return to setting up an organization to promote a country's foreign trade. An export orientation will be critical to Slovakia's growth strategy. An organization which can actively promote Slovakia's exports will be an important part of trade strategy.

Note: USAID's experience with institutions to promote Foreign Investment and Exports is favorable, with rates of returns conservatively estimated at 25 percent. As a part of its export orientation, Slovakia could also benefit from assistance to privatize its tourism sector and to promote Slovakia as an attractive tourism destination.

Private Sector Development of Economic Infrastructure. Slovakia needs to develop its economic infrastructure (transportation, power, telecommunications, environmental services) in order to grow. However, the costs are high, and the government must restrain expenditures to maintain economic stability. Means of enabling the private sector to supply most economic infrastructure have been developed in many other countries using the Build-Own-Operate and Build-Operate-Transfer methods. It would be advantageous for Slovakia to develop a similar mechanism in view of its huge infrastructure needs. A detailed paper prepared at the request of the Ministry of Economy and enclosed in this final report describes how such a program could be initiated.

Dip. Ing. Ludovit Cernak, CSc.
Minister
Ministry of Economy of the Slovak Republic
Mierova 19
827 15 Bratislava

December 23, 1992

Subject: Inception Report

Dear Mr. Minister,

Following our meeting of Wednesday, December 16, I am pleased to enclose, as discussed, an inception report with some initial comments and recommendations on the industrial policy paper.

As you further requested, I will be pleased to work on the detailed development of the industrial policy paper in January in preparation for its submission to the Economic Board. This provision of advisory services under Delivery Order No. 15 by Deloitte Touch awaits AID-Washington's approval to extend the delivery order's present expiry date of December 31, 1992. We understand that this approval is expected shortly.

It has been a pleasure working with you and your staff, who have made me feel most welcome. With cordial wishes for a pleasant holiday season and a successful 1993,

Sincerely,

Michael P. McLindon

Inception Report: Ad Hoc Advice to Ministry of Economy
(USAID Delivery Order No. 15)

Background. This inception report covers the period spent by the advisor (Michael McLindon) in Bratislava from December 4 to 22, 1992. This consultancy was a part of Delivery Order No. 15 between AID-Washington and Deloitte Touche. It follows a scoping mission undertake by Eliot Berg from September 29 to October 3, 1992 in Bratislava, which provided a valuable orientation for the current assignment.

During the first week a number of meetings were scheduled to provide an introduction to the current economic situation in Slovakia. A list of meetings and briefings held is appended to this report.

During the second week, the Minister of Economy, Ludovit Cernak, requested the advisor to assist in further developing the Ministry's paper on industrial policy for presentation to the Economic Council in January 1993. The Minister requested a short paper for December 23, outlining the advisor's comments on the industrial policy paper in its present form, with suggestions on how the industrial policy paper might be further developed. The Minister requested that the advisor's efforts in January be focused on detailed preparation of the industrial policy paper.

This report therefore contains the initial comments on the industrial paper, and presents some ideas for the Ministry's consideration on appropriate structuring and additions to the paper.

Current Status of the Industrial Policy Paper. The industrial policy paper at present has many positive elements to it, and is obviously the product of much hard work and creativity.

The current, and fairly lengthy, paper is in Slovak (all or parts of which will be translated into English in January). It explains the main features of Slovakia's industrial policy. The advisor's understanding of it is derived from several (interpreted) conversations that attempted to cover the main points of the paper. The paper cites the following global cost figures between 1992 and the year 2000:

Component	Crowns (Bil.)	Percent	
Structural Projects	295.9	55.3%	
Ecological problems	60.2	11.3%	
Energy efficiency	29.3	5.5%	
Others (not structural)	149.4	27.9%	
Total	534.8	100.0%	(= US $19 bil.)

(The word billions as used in the report follows the American meaning of a thousand million.)

The Slovak version also proposes a fund to help finance some of the proposed projects. This Fund would be composed of financing from several different sources, including the state budget, to help finance projects. This section of the paper will be translated in January, at which time detailed comments can be made.

An annex of the industrial policy project has been translated into English and contains brief project descriptions and cost figures. This part lists about 120 projects that are proposed at a preliminary level as part of the industrial policy. However, parts of the list include projects that are already underway, so that the cost figures do not coincide precisely with the Slovak version of the industrial policy paper. The following resources are estimated to be required for the following sectors, as per this translated annex:

Sectors	Crowns (Billion)
Fuel and Energy--Energy	102.9
Fuel and Energy--Gas	39.3
Electrotechnics	1.6
Wood Processing	15.0
Production of Building Materials	3.8
Building Industry	31.8
Light Industry	3.6
Chemical Industry	17.7
Mech. Eng.--Conversion	11.9
Mech. Eng.--Without Conversion	6.5
Ore and Classic Mining Industry	5.1
Ferrous Metallurgy	18.7
Nonferrous Metallurgy	10.5
Total	268.4 (= US $9.6 billion)

It is evident that the projects discussed represent an initial master list that constitutes the first step of the project cycle. With the possible exception of a few projects that are ongoing, and require further financing for completion, most of the projects have yet to undergo any feasibility test, including economic and financing viability.

This apparently need not concern the government directly, since the paper seems to indicate that the industrial policy projects will rely on financing predominately from the private sector enterprises and banks, and from foreign investment. The burden for feasibility analysis, project development and financing would presumably rest with the private sector making these investments. And, logically, the private sector would also identify new projects and investments not foreseen by the industrial policy paper that were otherwise consonant with Slovakia's competitive advantage and industrial and commercial interests.

The Slovak version of the paper lists the estimated sources of financing for the industrial policy as follows:

Source of Financing	Crowns Bil.	Percent
Companies' own resources	243.7	45.6%
Domestic bank loans	175.8	32.9%
Direct part of state budget	33.2	6.2%
Foreign banks	77.3	14.5%
Other	4.8	0.8%
Total	534.8	100.0%

Clarification is required on exactly what is intended from some of these sources of financing. Does "companies' own resources" imply that companies will be able to direct their own resources (presumably retained earnings, proceeds from share issues, equity injections from joint ventures, etc.) as they see fit, i.e., as a result of the usual analysis and feasibility studies that go into capital projects? Will these companies be by and large privatized companies? Or will these expenditures be made by enterprises that remain in the state sector at the behest of government planners?

The intentions with respect to the other major source of financing, domestic bank loans, is also important to clarify. Will these loans be made by the (privatized?) banks as a result of their internal assessment, or will the banks merely serve as passive conduits of credit for decisions made at higher government levels?

As the following section discusses, an industrial policy that relies on decision making at the firm level by private sectors entrepreneurs and bankers in response to their own assessments of risk and return, and complemented by an enabling environment and suitable economic infrastructure, would be the most appropriate.

Basic Approaches to Industrial Policy. If the industrial policy paper does not do so already, it might be helpful to discuss briefly the two basic approaches that a government can take towards industrial policy.

These two approaches are:

Interventionist: The government's role is to direct financial resources to targeted sectors and companies.

Enabling: The government provides and facilitates the economic, legal, marketing and related infrastructure to foster the proper environment for industry and commerce to develop and prosper on an enterprise basis.

The Ministry's industrial policy, as indicated by its proposed financing plan, seems to be by and large following the enabling form of industrial policy (subject to clarification of the points mentioned above.)

The "enabling" approach would be the best type of industrial policy for Slovakia for several reasons. Essentially, it is, if properly implemented, more consistent with both macroeconomic stabilization and structural reform of the economy than the interventionist approach.

First, the enabling approach is correctly attuned to Slovakia's budgetary realities. An interventionist approach implies much larger budgetary outlays for the government than an enabling approach. The large budget deficits that would be entailed by an interventionist industrial policy could very well have adverse effects on the money supply, inflation and a stable exchange rate. The integrity of the new Slovak currency will depend on limiting budget deficits. There is only limited scope for increasing tax revenues, and beyond a certain point, taxes would have adverse impacts on the emerging private sector and on foreign investment. Restraint will therefore be required on the expenditure side of the budget. The budget simply cannot afford high levels of capital spending and transfers.

Second, an "enabling" approach avoids the problems that have occurred when other governments have adopted interventionist policies. Countries that have adopted this approach, such as Korea, are now trying to liberalize their economies because of the revealed problems of the interventionist approach. If governments choose wrong, as the Korea's did when it directed companies to enter the heavy industries at a time of world overcapacity, it can be very costly for government and industry alike. (Korea's rapid development is often cited as an example in support of an interventionist policy. In fact, it was the country's export orientation, and the extraordinary industriousness of its people, that accounts for its success. Government is retreating from the interventions mode because of its revealed deficiencies.)

Third, an interventionist policy also tends to retard development of capital markets. This is because the banks act as passive conduits of credit to industry, and fail to learn loan appraisal, risk measurement and portfolio management techniques. Because interventionist financing is typically in the form of debt, companies have large debt/equity ratios, which makes them vulnerable to cash flow problems during recessions. They have little incentive to raise equity financing, which stifles the development of a stock market.

The enabling approach does not imply passivity on the part of the government, or abandoning its stewardship of the public interest. On the contrary, it requires the enactment many pro-active measures to foster a suitable environment, as discussed below.

Elements of Industrial Policy. The following constitute the main elements and required government measures of a "enabling" approach to industrial policy. These elements encompass a fairly wide range of areas, some which may fall outside the direct scope of responsibility of the Ministry of Economy. Since it will be highly desirable to adopt policies in a number of cross-cutting areas in order to promote industry and commerce, it may be advantageous to consider an "Industrial Policy Committee" or the like composed of members from different ministries and agencies to ensure that complementary policies are adopted and implemented.

Privatization. Privatization should continue to be the primary instrument for industrial policy and restructuring. This is appropriate, since restructuring for the most part can be undertaken most efficiently by the private sector.

The government should also consider a new form of privatization, the Build-Operate-Transfer (BOT) approach to infrastructure to help it deliver a competitive economic infrastructure required for its industrial policy while getting the private sector to finance most of the costs.

For presentational and analytical purposes in the industrial policy paper, it would be helpful to get a list or breakdown by sector of companies that have been privatized and are to be privatized, and which companies, if any, the government plans to retain.

Foreign Investment. Given low level of domestic saving in Slovakia, the need to increase investment to promote growth, the need to replace aging and obsolete technology, to introduce new management techniques and training opportunities, and to gain market access to the West, foreign investment will be critical to industrial policy.

In the intensely competitive world of trying to attract foreign investment, the marketing of Slovakia as an attractive destination for foreign investment is essential, and an area that requires government support. The marketing and promotional aspects seem to be off to a good start under SNAFID, but more funding is needed. Policies affecting foreign investment have some attractive features, but the government should consider, inter alia, extending the two year tax holiday period.

Foreign portfolio investment, i.e. the purchase of small percentages of a company by foreign investors, especially foreign stock fund managers, can be an important source of demand for the shares of companies, which support prices and can encourage the growth of equity financing. Current policies that affect foreign portfolio investment, such as taxes on dividends and capital gains, currency convertibility, etc., are not clear yet, but hopefully will be facilitative of this important form of investment once the stock exchange has commenced operations.

Export Orientation. In view of the relatively small size of the domestic market (5.3 million people) it will be important to establish an outward looking, export oriented trade policy as a part of industrial policy. This already appears to be in progress with a free trade agreement among Slovakia, the Czech Republic, Hungary and Poland that would reduce duties on industrial and agricultural goods by 2001. Continue relations with the European Community also appear to be in the offing.

Tourism can be considered as a part of the export orientation (the balance of payments considers tourism as an export of services.) Slovakia clearly has tourist potential. At the same time, there is a large western market looking for new tourist destinations. Much of tourism development will depend on the development of general economic infrastructure by the private sector as discussed below, but marketing and advertising of Slovakia as a tourist destination is a area that can benefit from government support. Perhaps a master plan for tourism development, delineating areas of action for local and foreign private sector, and the Slovak government, would be helpful.

Development of Capital Markets. The creation of a dynamic capital market, which facilitates the transfer of savings to productive investment in industry and commerce, is also an important component of industrial policy.

By avoiding an interventionist policy, the government, as noted above, can help to avoid the government planned flows of capital that vitiate the development of a sound capital market. The further privatization of state owned banks will also help to develop capital markets.

The government can also take other steps to create an enabling environment for a capital market. A stock market will be important not only to trade shares of privatized companies, but also to encourage companies to sell shares to raise equity finance. The essential elements for promoting stock market development include:

(1) A public awareness campaign to promote an understanding and awareness of the benefits of owning shares.

(2) Some sort of regulatory environment (though not overly burdensome) to protect investors interests.

(3) The development of exchange operations

(4) Policies to promote the supply of shares

(5) Policies to promote the demand for shares

The government has an enabling role to play in at least items 1, 2, 4 and 5.

Slovakia could also consider a liberal regime for foreign exchange controls and related measures to encourage foreign banks to set up branches. If Slovakia is successful in being a crossroads for trade between East and West, there is no reason why international finance should not follow.

Facilitate Provision of Economic Infrastructure. Economic infrastructure--power, telecommunications, transportation (highways, roads, bridges, ports, airports), industrial estates, and environmental management (such as solid waste and waste water) are critical physical components in the enabling environment.

The needs and costs of economic infrastructure to support modern industry and commerce in Slovakia will be enormous. Fortunately, the government does not have to bear the burden of these investment costs alone. Under a relatively new technique known as Build-Operate-Transfer (BOT) infrastructure privatization, the government can bid out these infrastructure projects to the private sector, which, under a concession awarded to it by the government, assumes the responsibility for the financing, construction, and operation of the infrastructure project.

Typically, a BOT project is sponsored by a contractor and equipment supplier who build and operate the required infrastructure for a predetermined number of years. BOT projects must be commercially viable so lenders can be repaid from project revenues, and investors can earn an acceptable rate of return. Although small projects are possible, and even desirable at the beginning of a program, BOT projects tend to involve large sums of money, are highly leveraged, and of long duration. As a result, BOT projects often include a large foreign investment component.

Notable BOT projects in developing countries include the Malaysian North-South Expressway ($1.8 billion), the Bangkok Second Stage Expressway ($880 million) and the Shajiao Power Plant ($550 million) in the People's Republic of China.

Energy. It is important to note that over half of the costs identified in the English version annex (see above) of industrial policy projects are for the energy and gas sector. Thus, energy and gas projects are costed at 102.9 and 39.3 billion crowns, respectively, or about US$ 5 billion for both energy and gas, out of the total US $9.6 billion.

With the proper design of the privatization program, most of the costs for this component could be born by the private sector.

A brief review the plans for energy sector privatization reveals much creativity. Apparently, the Ministry of Economy plans to finalize the privatization proposal shortly, which will then be reviewed by the Ministry of Privatization and implemented with the help of outside consultants.

It would advantageous to have outside advisors with experience in energy sector privatization in other countries be consulted at the design stage of the privatization. Some concerns with regard to the present proposal are the complicated corporate structure, the need to consider as a part of the privatization the use of BOT type power purchase agreements to facilitate private sector generation of power, and the need to develop a satisfactory tariff and regulatory structure.

The gas pipeline could also be build with private sector financing. One possibility might be put out for bid a concession to enable a private sector interest to build, operate and finance the pipeline in return for a revenue sharing agreement with the government. The winning bidder could be selected from among those who propose the most advantageous revenue sharing agreement for the government subject to constructing and operating the pipeline according to specifications.

Telecommunications. One important area of economic infrastructure that seems to be underweighted in industrial policy considerations is telecommunications. The present state of telecommunications is simply inadequate to support restructured and revitalized industry and commerce. Modernization of the system is urgently required. The easiest and best way to do this is through privatization--nearly 100 countries at present are considering privatization under traditional and/or BOT approaches. Telecommunications is also an area where the foreign private sector can be expected to shoulder a large portion of the financial burden if the enabling environment is satisfactory.

<u>Transportation</u>. Slovakia will also need to attract private sector investment to build and upgrade highways and other transportation facilities, such as bridges and river ports, if it is to act as a trade crossroads between East and West. Airport developments will also be required. These infrastructure needs can be accomplished in large part through the BOT privatization mechanism described above. The development of transportation will also help to develop tourism, as noted above.

<u>Development of Administrative and Legal Framework</u>. Time has not permitted a detailed review of the current status of legal developments, but the administrative and legal requirements for industrial policy will include a legal structure that includes basic contract and commercial law; protection of property rights including intellectual property; a framework for competition; a mechanism for dispute resolution, and information about corporate tax, import licensing, customs clearance and related business practices.

<u>Role of Industrial Policy in Overall Economy</u>. In the industrial policy paper, it would be useful to give a brief overview of the Slovak economy since 1989, as well as projections about growth, inflation, unemployment, balance of payments, etc. This will help to place industrial policy within the overall framework of the economy.

It would also be useful to state briefly the government's overall economic policy, e.g. that it wants to encourage rapid growth to improve the standard of living, foster an enterprise economy, etc. Slovakia's geographic position and busines contacts within the former Soviet Union make it a natural locus to act as a crossroads for trade between east and west. Its competitive advantage also lies, in addition to geographic position, in a low cost but well educated and skilled work force.

Appendix I.

List of Meetings

Ad hoc economic advise to the Minister of Economy of the Slovak Republic Mr. L. Cernak and staff.

Michael McLindon. USAID Delivery Order No. 15. December 3 to December 23, 1992

Date: Friday, December 4

9:30 Arrival in Bratislava via Vienna Airport. Introduction and briefings by staff of Deloitte & Touche.

18:00 Attended reception of the law firm of Squire, Sanders and Dempsey. Informal discussions with members of advisory community and Slovak officials.

Date: Monday, December 7

8:00 Meeting with Mel Mraz, head of Deloitte & Touche office in Bratislava.

10:00 Meeting with Lubo Haluska, Deloitte & Touche. Briefing the Slovak economy and the Ministry of Economy.

12:30 Lunch with Ms. Patricia Lerner, U.S. AID Representative to Slovakia, Marian Krsko, Project Advisor with USAID, Mel Mraz and Robert Wood.

2:30 Briefing by Marian Krsko on privatization program.

Date: Tuesday, December 8.

10:00 Attended meeting at Istrochem (a chemical company) with Robert Wood, Katarina Csakanyiova, Rod Marshall, Marie Pribyl, Maria Buchova, and Julius Centik. Discussion on foreign investment and environmental concerns.

16:00 Briefing by Robert Wood on Istrochem and privatization program.

19:00 Dinner with Robert van Ling, Deloitte & Touche, Eastern

Europe Valuation Center. Discussion of valuations of enterprises in Slovakia and Eastern European countries.

Date: Wednesday, December 9.

9:00 Briefing by Pavol Lancaric, Deloitte & Touche.

12:30 Meeting with Minister Ludovit Cernak, Ministry of Economy.

16:00 Meeting with Paul Gibian, IESC advisor. Discussion of progress on defence conversion.

19:00 Dinner with Mel Mraz, Paul Greeman and members of Deloitte & Touche's London group.

Date: Thursday, December 10.

9:00 Meeting with Milos Lelovsky, State Secretary, Mrs. Sajtlavova, Heat of Strategic Department, and others. Discussion of strategic economic sectors.

12:30 Lunch with Len Rogers, Senior Technical Advisor at U.S. Department of Energy, and others. Discussion of Slovakia's energy sector.

15:00 Discussion of organization and functions of the Ministry of Economy with Dr. Anna Nemethyova and Ing. Viera Jureckova.

Date: Friday, December 11.

9:00 Meeting with Miroslav Galik, Foreign Services and Investment Department, Ministry of Economy.

14:00 Meeting with Josef Frankovsky, Head of Department of Mining and Metallurgy, Ministry of Economy.

Date: Monday, December 14

15:00 Marian Jezek, Vice Minister. Discussion of chemical and light industries in Slovakia. Modalites of privatization.

Date: Tuesday, December 15

10:00 Discussion of industrial policy paper with members of

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strategic department of Ministry of Economy

13:00 Detailed discussion of elements of Slovak version of industrial policy paper.

6:00 Meeting with Colin Adlum, advisor to SNAFID.

Date: Wednesday, December 16

8:00 Mrs. Anna Jostiakova, Head of Trade Policy Sector, Ministry of Economy.

13:00 Dir. Secko, energy section, Ministry of Economy. Overview of energy sector and privatization plans.

14:00 Minister Ludovit Cernak. Discussion of industrial policy and development of policy paper.

15:30 Anna Sirilova, Director of the Department of Light Industry

Date: Thursday, December 17.

7:30 Jack Fador, advisor to Ministry of Finance on budgeting.

9:00 Director Secko, energy department, Minsitry of Economy. Continuation of discussion of energy sector and its role in industrial policy.

11:00 Technical Policy Group, Ministry of Economy. Discussion of development of R&D capabilities and technology transfer.

13:30 Working session with Mrs. Sajtlavova on industrial policy paper.

Date: Sunday, December 20.

Attented reception by USAID Representative. Informal discussions with Tom Grey, Harvard Capital and former advisor to Ministry of Economy; Leighton Klevana, representative of Czech & Slovak American Enterprise Fund in Bratislava; Langedon Bell, Advisor to General Credit Bank.

Date: Monday, December 21.

7:30 Sara Ackerson, Securities and Exchange Commission.

Advisor to Ministry of Finance on development of stock market.

Date: Tuesday, December 22

10:00 Mrs. Sajtlavova. Review of recommendations on industrial policy.

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Dipl. Ing. Ludovit Cernak, CSc.
Minister
Ministry of Economy of the Slovak Republic
Mierova 19
Bratislava

February 15, 1993

Dear Mr. Minister:

I am pleased to submit, as per your request, the following report on "Private Sector Infrastructure Development: The Potential for BOO/BOT in Slovakia."

The BOO/BOT approach is of relevance for Slovakia and the Ministry of Economy, I believe, because it involves three areas of primary importance to industrial policy and overall economic policy:

- Infrastructure
- Foreign Investment
- Privatization

Naturally, I would be pleased to discuss this report with you further at your convenience.

Sincerely,

Michael P. McLindon

PRIVATE SECTOR INFRASTRUCTURE DEVELOPMENT: THE POTENTIAL FOR BOO/BOT* IN SLOVAKIA

Michael P. McLindon

Ministry of Economy

February 1993

*Build-Own-Operate, Build-Operate-Transfer

I. SUMMARY

Background. As a part of the ad hoc advisory services provided under Delivery Order No. 15, the Minister of Economy, Ludovit Cernak, requested the advisor (Michael McLindon) to assist in the further development of the Ministry's paper on industrial policy. This was completed by the advisor as an "inception report" in late December 1992.

After reviewing a draft document, the advisor recommended that the government adopt an "enabling" rather than an "interventionist" approach to industrial policy. This would entail the government's provision and facilitation of the economic, legal, marketing and related needs to foster the proper environment for industry and commerce to develop. The recommended specific elements of industrial policy included continued privatization as a primary instrument of restructuring, promotion of foreign investment, an export orientation, the development of capital markets, and facilitation of the private provision of economic infrastructure.

In the revised industrial paper, the Ministry of Economy (MOE) is giving particular emphasis to the provision of economic infrastructure. It notes that efficient and reliable economic infrastructure--in power, telecommunications, transportation, water supply and waste management--promotes industrial and commercial development.

The challenge will be to finance Slovakia's infrastructure needs. This report, following interests expressed by the Ministry, describes a state of the art mechanism for enlisting private sector finance and support for developing infrastructure through the mechanisms of BOO and BOT.

This report then further assesses the enabling environment for a BOO/BOT program in Slovakia and examines the policy and institutional framework for public/private partnerships in infrastructure.

Attention is given to setting up and properly staffing the technical unit which would be responsible for designing and implementing the BOO/BOT program. The requirements for effective project identification, screening, structuring, tendering, negotiation and award are also highlighted.

This report also looks at the legal parameters and precedents governing private participation in Slovakia and identifies the key areas required for a full "legal audit" in order to promote a BOO/BOT program.

The Three Phases of A BOO/BOT Program. Experience with BOO/BOT programs stresses that there are three basic stages in initiating a BOO/BOT program, though in practice they can overlap.

The first is the conceptual stage, where government officials (and the private sector) are exposed to the concept of BOO/BOT, and determine initially how they can best use a program to help it meet its objectives.

A second, critical step is the design stage. This involves further training, setting realistic goals and time horizons, identifying program components, activities, outputs and inputs, the development of program guidelines, arriving at a final decision on where to locate the BOO/BOT unit within the government and securing proper staffing and support, a full legal audit to determine if existing legislation must be amended and new legislation enacted, and a review of the financial sector.

Several governments, in their haste to move into the third state--implementation--have shortchanged, or skipped altogether, the design phase of the program. Regrettably, in the effort to save a few months, the implementation of the programs can be set back several years.

While a BOT program obviously cannot by itself meet all of Slovakia's challenges, it would in principle be a step in the right direction and consistent with the policies and strategy that Slovakia is trying to adopt to support sustainable growth.

II. INTRODUCTION: THE SETTING AND RATIONALE FOR A BOO/BOT PROGRAM IN SLOVAKIA.

BOO/BOT: Definitions. Several governments, such as Turkey, Malaysia, Pakistan, the Philippines and Sri Lanka have promoted a concept for the financing of public sector projects known as "Build-Own-Transfer" (BOT), or "Build-Own-and-Operate" (BOO) agreements.

Typically, a BOT project is sponsored by the contractor and equipment supplier(s) and other investors who build and operate the infrastructure facility for a predetermined number of years. At the end of this operating period, the project is transferred to the Government. Such BOT projects are required to be commercially viable so lenders will be repaid from project revenues and the investors will earn a satisfactory rate of return.

The fundamental requirement of the BOT concept is a contract between the ultimate users of the infrastructure and the operating company (typically managed by the project sponsor) for the use of or production from, the facility. The price charged by the operating company must cover operating and financial charges, including return on investment. The period of operation of a BOT project is typically 10 to 20 years following the commencement of full operations, although occasionally it can be much longer.

Under the BOT concept, the contractor or equipment supplier is typically the project sponsor and the major equity investor. The sponsor is also responsible for managing the operating company. Other investors may be added to the equity ownership of the operating company.

Given the size of most BOT projects, the BOT company will need to attract large amounts of debt financing. Banks and other commercial lenders need to evaluate the project based on several factors. These include the strength of project cash flows, the ability and financial commitment of the sponsors to build the facility, on time and within budget, and the capability of the operating company to manage costs and successfully maintain and operate the facility.

The typical BOT company and the related agreements are demonstrated in Figure 1.

Why BOT Today: Rationale. In recent years the overwhelming need for investment in infrastructure has confronted governments in developed and developing economies alike. However, as is the case with Slovakia and other Central and Eastern European countries which are moving to a market economy, insufficient resources have made it difficult to meet even modest objectives.

Recent studies analyzing the relationship between high quality, reliable infrastructure systems and economic development have established that competitive economic infrastructure creates employment, promotes local and foreign investment, fuels business productivity and expansion, and contributes to raising standards of living and access to social and economic services.

Moreover, studies also reveal that inadequate infrastructure represents an enormous drain on a national economy. The financial costs alone of brown- and black-outs in the power sector are significantly higher than commonly realized, as are the lack of modern telecommunications in the competitive information age.

Further, the lack of adequate transportation networks stifles business activity. The environmental degradation and associated financial and human costs of poor systems of water supply, water treatment, and waste management not only threaten ecosystems and lives but are incompatible with long-run economic growth and development.

The difficulty in providing these systems traditionally has been the perception that they are public services, often provided free of charge, and that they must be developed and financed through government expenditures. Of course, when provided and structured in this manner, the impression has unfortunately been created that infrastructure, while essential to economic development and growth, lacks commercial viability. The equally erroneous corollary is that only governments can provide such infrastructure.

This is inadequate for a country that has ambitions of taking advantage of its substantial physical, economic, and human attributes and potential. Fortunately, there are technical, managerial, and financial alternatives available today to alleviate this critical development bottleneck: public/private partnerships which utilize the BOO/BOT method.

<u>State of Infrastructure in Slovakia</u>. Infrastructure in Slovakia is at a crossroads. Saving gaps in the economy, limited budgetary resources, limited absorptive capacity of the bureaucracy, difficulties in finding funds in times of necessary fiscal austerity and other problems imply that the infrastructure projects needed for sustainable economic growth will not necessarily be identified, financed or implemented.

Opportunities appear available for timely implementation of infrastructure projects under cooperative efforts of the public and private sectors. A brief overview of leading economic infrastructure sectors indicates an important role for a BOO/BOT approach as a part of Slovakia's enabling philosophy of industrial policy.

<u>Transportation</u>. If Slovakia is to act as a crossroads between East and West, it will need to attract private sector investment to

build and upgrade highways, provide maintenance, and other transportation facilities and services, such as bridges and river ports. The proposed rail link between Bratislava and Vienna might also lend itself to a BOT approach. Airport developments will also be required. These infrastructure needs can be accomplished in large part through the BOO/BOT privatization mechanism described above. The development of transportation will also help to develop tourism, another component of Slovakia's industrial policy.

Energy. It is important to note that over half of the costs identified by the Government of Slovakia as a part of its industrial policy are for the energy and gas sector. Thus, energy and gas projects are costed at 102.9 and 39.3 billion crowns, respectively, or about US$ 5 billion for both energy and gas.

With the proper design of the privatization program, most of the costs for this component could be born by the private sector. The government should to consider as a part of the privatization of the power sector the use of BOT type power purchase agreements to facilitate private sector generation of power.

The gas pipeline could also be built with private sector financing. One possibility might be put out for bid a concession to enable a private sector interest to build, operate and finance the pipeline in return for a revenue sharing agreement with the government. The winning bidder could be selected from among those who propose the most advantageous revenue sharing agreement for the government subject to constructing and operating the pipeline according to specifications.

Telecommunications. Another vital area of economic infrastructure is telecommunications. The present state of telecommunications is simply inadequate to support restructured and revitalized industry and commerce. Modernization of the system is urgently required. The easiest and best way to do this is through privatization--nearly 100 countries at present are considering privatization under traditional and/or BOT approaches. Telecommunications is also an area where the foreign private sector can be expected to shoulder a large portion of the financial burden if the enabling environment is satisfactory.

Fortunately, Slovakia possesses many of the characteristics that may determine the successful implementation of BOO/BOT projects, notably:

- A skilled, well educated work force.
- An economy with tremendous upside potential for business over the long run once economic reform takes root.
- A desire to promote local and foreign private sector investment.

- Growing demand placed on existing infrastructure and a recognition of the importance of new, more efficient systems.

- Growing reputation as an attractive investment location, based on reasonable labor costs.

- Commitment by the Government to promote private enterprise and market-oriented approaches to economic development.

These points are examined in further detail in the following section.

III. THE ENABLING ENVIRONMENT FOR BOO/BOT PROJECTS IN SLOVAKIA

In order to realize the objectives of a BOO/BOT approach to infrastructure development, one must assess the viability for implementation in Slovakia.

Generally, five principal indicators must be satisfied in order to realistically state that public/private partnerships can and will succeed in any one country. They are:

1. <u>Policy and Institutional Environment</u>. For public/private partnerships to emerge successfully in Slovakia, it must demonstrate the capacity to:

(1) Commit to a program of stabilization and structural reform.

(2) Establish the policy and institutional procedures that support BOT "partnerships" between the public and private sector.

Slovakia is making progress in achieving the first item. Without relenting on achieving the first, it should aggressively pursue the second. The second, in fact, is a key part of what has been referred to as the design phase of a BOO/BOT program.

Although it is important that there is a demonstrated commitment to promoting the private sector, more important is a demonstrated commitment to respect commercial agreements, adjudicate disputes without prejudice, and serve as a reliable institutional and administrative partner with the private sector over the long-term. The outlook here is quite postive for Slovakia.

By initiating a program of public/private partnerships and by laying the foundation for managing the process through legal, institutional, and administrative instruments such as Program Guidelines and a technical unit, Slovakia can demonstrate commitment through action.

2. <u>Business Environment</u>. Another indicator important in assessing the prospects for a successful public/private program is the business operating environment.

Generally, it is not enough to promote the transfer of public assets to the private sector nor to encourage the creation and sustainability of institutions that support private transactions. It is equally critical to demonstrate that the operating environment for business undertakings is sound and will be sustained over the life of the project.

In Slovakia the business operating environment appears to be much more favorable than in the past, thanks to its ongoing restructuring efforts and encouragement of investment. These measure, however, require consolidation and further strengthening. It is important to remember that Slovakia is in competition with other countries, in Europe and the rest of the world, that are also creating hospitable, pro-market environments.

<u>3. Demand for Services</u>. Clearly, an important indicator in determining program and project viability is the demand for the service in question.

The structuring of the project and related agreements is then critical so that the risks are shared and mitigated so as to promote long-term viability and a capacity to absorb external shocks affecting its market.

The demand for services in infrastructure may be the primary indicator of project success. If governments are committed to providing a service that the consumer deserves and demands, experience has shown that they will provide that service.

For the most part, governments now recognize that they can deliver services with the participation of the private sector primarily due to the pent up demand for the service in question.

In Slovakia, like other countries, the demand for infrastructure exists and a number of projects, if structured well, could be developed to meet existing and future demand.

However, the question of what the consumer can afford to pay is still uncertain. That is why careful project identification, screening, and structuring must be done so that projects are developed that meet demand now and in the future and they are geared and priced to succeed. Only by skillful project structuring can good project candidates become "bankable" project realities.

<u>4. The Legal Setting</u>. The legal environment in Slovakia appears to be generally supportive of private investment.

One important consideration will be to decide if a BOO/BOT law is necessary. The key question is whether the existing Slovak legal regime will permit BOO/BOT projects to be structured so as to project both the interests of Slovakia and the potential project sponsors and their lenders, while facilitating the implementation of the projects.

To do this, Slovakia would be well advised to undertake a "legal audit" of existing legislation to see if it poses any potential problems for a BOO/BOT program. The audit needs to examine four general categories of law in Slovakia:

> <u>Laws of general application to commercial activities</u>: Relevant types of laws in other countries have included the Companies

Act, the Tax Act, Exchange Control Act, Land Acquisition Act, Industrial Promotion Act, various bilateral investment promotion and protection treaties, treaties against double taxation, etc.

Laws governing specific sectors of the economy: In other countries these have included the Electricity Board Act, Transport Board Act, Ports Authority Act, Water Resources Act, Industrial Estates Corporation Act, Road Development Act, Telecommunications Act, etc.

Laws on investment activities.

The Constitution.

Experience indicates that when specific projects require additional legislation, such legislation should be in the form of amendments to existing state corporation acts, not the in form of free-standing, new legislation.

Such a legal audit would take about three weeks to perform by a lawyer or BOT specialist.

5. Finance. The scope for participation by local financial institutions in BOO/BOT projects is limited by the current underdeveloped state of the financial system and capital markets in Slovakia.

Slovakia's financial markets are "emerging" and not ready to assume the amounts and maturities that would be required for most BOT projects. However, they can hopefully play a small role in the future.

The difference between the amounts required for BOO/BOT projects and what can be sourced locally would have to come from foreign sources. The scope for private foreign debt financing of BOT projects is limited by foreign perceptions of country risk, although this can be mitigated to some extent by a concerted policy and marketing effort. Realistically, the capacity of foreign lenders to assume high levels of project risk in Slovakia is probably limited in the short run.

Thus, for its larger-scale projects in the short to medium run, Slovakia can try to avail itself of project financing from the International Fiance Corporation (IFC).

Slovakia should also consider working with official donors such as the World Bank, USAID and other bilateral donors to establish a mechanism to access official development assistance (ODA) to make funds available, through appropriate conduiting institutions in Slovakia, for onlending to the private sector for BOO/BOT type infrastructure projects. Such a mechanism would help to use ODA more efficiently and avoid current problems with counterpart funds.

Over time, as the foreign perception grows, private foreign capital should hopefully play an increasing role. Concomitantly, as Slovakia's financial markets develop during the 1990s and beyond, local private sector agents can be expected to assume a growing role in the financing and development of infrastructure.

Thus, as a part of the design phase of the BOO/BOT program, an analysis of the ability and interest of the local financial markets should be undertaken. This should aim at identifying likely sources of debt and equity finance for BOO/BOT projects, and the likely terms and conditions.

IV. INSTITUTIONAL AND ADMINISTRATIVE FRAMEWORK FOR A BOO/BOT PROGRAM IN SLOVAKIA: STEPS IN THE DESIGN PHASE

A critical part of the conceptual and design phases of Slovakia's BOO/BOT program will be the administrative location of the BOO/BOT technical unit.

Experience in promoting the participation of the private sector in the development and provision of infrastructure indicates that a structured framework is advisable.

It is recommended that Slovakia initiate the focal point for public/private partnerships and place it within a framework that at least meets the following criteria:

1. Highest office possible with access to and linkages with the Cabinet and the Office of the Prime Minister.

2. The focal point has direct linkages, either through affiliation or sub-committees/secretariats relationships with the implementing agencies deemed eligible for BOO/BOT projects. In Slovakia this would include the agencies responsible for transportation, power, water, waste management, industrial estates, and telecommunications.

3. The focal point has some formal relationship with the department responsible for infrastructure development and planning so as to access information and consolidate experience.

4. The focal point has an institutional affiliation that allows dialogue with the private sector.

5. The focal point has an institutional relationship with the body responsible for coordinating development assistance so as to leverage the participation of donors in this process smoothly.

6. Finally, the focal point be given authority not only to plan and analyze possible transactions but to evaluate and recommend their merit in accordance with technical criteria with the input of the relevant line agency and the supervisory body governing the focal point.

It has been recommended at this point that the focal point or technical unit be established within the Ministry of Economy. This configuration appears to meet the above six criteria through its permanent affiliation with all the relevant line agencies and the Ministry of Finance.

Modus Vivendi. More important than the placement of the technical unit itself is the authority and designated functions of the unit vis-a-vis the other agencies involved in infrastructure development and economic policy.

It is vital that the unit can work effectively with the line agencies in a coordinating capacity. It must be perceived as being "responsible" for certain tasks in planning and implementing BOO/BOT: project identification, project analysis, project conformity to guidelines, project administration, project review and recommendation, and project monitoring. It should be vested with that authority in total.

Program Guidelines. Program guidelines serve to establish the rules of the game and the framework in which the public sector and the private sector can proceed with BOO and BOT.

Program guidelines need not be detailed nor burdensome. They ideally should articulate the governments objectives in pursuing BOO and BOT projects and outline the processes through which eligible projects and project proponents can advance.

Again, not surprisingly, the countries that have developed broad-based yet concise program guidelines that represent accurately the technical, legal, financial, and political objectives and requirements of the Government in question are the countries experiencing success with BOO and BOT.

Setting Up the Technical Unit. The successful privatization experiences of other countries present valuable lessons learned for Slovakia, especially for establishing an effective technical unit.

In addition to formulating effective institutional bodies and procedures such as Program Guidelines and streamlined authority, most technical units were characterized by a professional approach to administering and managing the process of public/private partnerships.

Without the effective coordination and staffing of a technical unit to plan and manage this detailed process, it is very unlikely that any of their efforts would have been successful.

Top Quality. It is important to recruit, from within and outside government, the best and brightest. Programs such as these are far too important not to have professionals equivalent to any other government agency responsible for implementing projects of national priority.

A BOO/BOT program could be responsible for planning and managing hundreds of millions of dollars of projects, representing untold savings for the government while providing services to millions of people. The sense of responsibility, and the quality of staffing, should be commensurate.

A Lean, Flexible Unit. Quality and quantity should not be mistaken. The last thing a high-level economic policy implementation unit should be is another layer of bureaucracy. The unit for a BOO and BOT program should be lean and focused. It should start with adequate resources and have the capacity to grow as required.

Train Early and Often. Regrettably, most of the officials responsible for privatization in developing, emerging markets, and former socialist nations, did not receive early training in privatization nor did they anticipate that they would require it as much as they do.

The countries that successfully implemented privatization in the last five years and the countries that will successfully implement BOO and BOT projects in the next five years will have at least one thing in common: small but capable staffs well-trained in the variety of technical and political issues found in public/private affairs.

Responsibilities of BOO/BOT Technical Unit. Serving as the institutional center for the evolution of public/private projects in Slovakia, the technical unit would be vested with the following five primary program responsibilities:

1. Ensure that proposed project candidates meet established socio-economic, technical, and environmental policy criteria.

2. Ensure that proposed projects conform to "Program Guidelines" and governing acts and procedures.

3. Administer, through working with the supervisory bodies overseeing BOO and BOT implementation and the line agencies, the processes of project development.

4. Through negotiation, with the input of relevant technical committees and line agencies, review and recommend to the Cabinet a decision to accept, reject, or table proposed projects.

5. Monitor and evaluate approved and implemented projects.

Staffing of Technical Unit. In order to perform these five primary program tasks, work closely with supervisory bodies, the line agencies, the private sector, the donor community, consultants, and the variety of secondary tasks required for program success, it is recommended that the technical unit be staffed with the following.

Unit Director. The Unit Director would be responsible for overall management of the program and would be the chief representative of the unit to Cabinet, the line agencies, and the private sector. In effect, this individual will champion the unit technically and politically and will require a knowledge of not only how government agencies operate and policy is implemented but possess a keen understanding of the private sector as well.

Assistant Director. The Assistant Director would have direct responsibility for program management and would assist the Director in program and project completion. It is suggested that this individual also be adept at program marketing and project packaging.

Financial Analysts (2). Qualified financial analysts familiar with capital projects in Slovakia are required. Preferably, individuals who have experience in public and private sector financial analysis and infrastructure project analysis as well would be preferable. Computer skills should be required for financial modeling and pricing.

Infrastructure Specialists (2). Preferably, technical specialists familiar with the six areas of infrastructure identified as eligible in the BOO and BOT program including water, power, transport, telecommunications, and industrial states. Engineering background in at least one of the above areas and familiarity with infrastructure planning and operations should be required.

Environmental and Legal Officers. Ideally, the unit would have in-house environmental and legal officers. While resources and/or availability may not permit this, these functions will be critical to the long-term program. Both of these functions if necessary, could be provided by consultants or local experts.

Administrative and Production Staff. This area should not be understaffed. If initiated at full-scale and working with foreign consultants, line agencies, supervisors, and the private sector, the unit will be responsible for reviewing and generating volumes of studies, reports, marketing materials, and presentations. Significant amounts of detailed financial, technical, engineering, legal, environmental, and marketing material will be required.

At a later date a more detailed organizational, administrative, and training plan will need to be developed to determine final administrative needs and design. This will be based on the final conclusions and objectives of the Government regarding the character of the proposed technical unit and the resources available to devote to this important policy implementation team.

V. PROCESS FOR IDENTIFYING AND PROCESSING BOO/BOT PROJECTS.

As the first step in the development of a BOO/BOT transaction, the project identification process plays a vital role in determining the future possibilities of the entire BOO/BOT program. The project identification process is the foundation upon which the entire pyramid rests.

Unless this foundation is broad enough, and a suitable quantity of economically important and financially attractive BOO/BOT project candidates are added to the inventory of Slovakia's BOO/BOT program, there will not be a sufficient number of projects at the "top" that are fully studied, bid-out, evaluated, negotiated, and constructed. More important than quantity, however, is the quality of the projects identified to be structured on a BOT basis.

The Master List. The first step in project identification is to develop a Project Master List. This list of potential BOO/BOT candidates is developed through the collection of data, consolidation of existing feasibility studies, and analysis of sectoral candidates from the power, transport, telecommunications, waste management, water and industrial estates sectors.

The Role of Demonstration Projects. In order to ensure that viable program and project objectives and outputs are achieved, viable demonstration projects need to be developed.

Reviewing the transaction history of countries that have successfully introduced privatization such as Malaysia, Mexico, Chile, Pakistan, etc., confirms that successful demonstration project implementation formed the basis for overall program success. The implementation of successful public/private partnerships through BOO and BOT demonstration project is no different.

Moreover, projects in areas such as water supply and treatment, as well as solid waste areas require special consideration in the project identification and analysis stage due to their unique project structure and the unfamiliarity on the part of the consuming public with paying for service in these sectors.

Experience in identifying, structuring, and implementing BOO and BOT projects has revealed that it is the selection and determination of viable demonstration projects that is the greatest constraint to project implementation in developing countries.

Countries that have had difficulty in implementing BOO and BOT projects such as Turkey, Thailand, and Pakistan, for example, all selected initial project candidates that were far too difficult from a financial, economic, legal, and technical nature to be completed successfully and expediently.

In order for a successful BOO or BOT project to emerge in Slovakia, a project candidate must meet at a minimum, a certain threshold of criteria that determine if it can advance on a BOO or BOT basis:

1. A market for the service in question really exists.

2. Sufficient revenues can be developed and that the income steam can be captured with minimal political and financial risk.

3. The political will exists to develop and support the project over a long period of time.

4. The public is willing to pay a "market" price for the service in question.

5. No new or untested technology is essential to successful project performance.

6. The project can be financed on a non or limited recourse basis.

7. The complexity of the project is not so overwhelming that the timetable can not be realistically met, thereby rendering null any demonstration value.

There are a number of other project characteristics that will need to be assessed for any project candidate to advance through the screening process. These include financial, technical, economic, legal, and environmental standards of analysis. Importantly, all demonstration projects require a project structure that will ensure success.

<u>Structuring Demonstration Projects</u>. Most projects will need to be structured so that the chances of project success are enhanced.

Typically, this calls for a greater sharing of the risks and responsibility between government and the private sector that might ordinarily be required in future transactions. In fact, one objective of BOO and BOT in the long run is to promote projects that can stand alone.

However, initially, projects will require some degree of support that can help to mitigate risk while at the same time still achieve many of the objectives of BOO and BOT in Slovakia.

The types and forms of support that will likely be required in Slovakia to support demonstration projects may include:

1. Political and Bureaucratic Support

2. Fast-Track Legal Framework

3. Assured Supplies, Dedicated Assets

4. Assured Revenues: Take or Pay Arrangements

5. Loans or Equity Contributions

6. Earning Assets

7. Fiscal and Commercial Incentives

8. Right of Way or Eminent Domain Assistance

BOO/BOT Project Screening and Analysis. If the project identification process forms the foundation of the BOO/BOT "pyramid," then the project evaluation process determines the slope of the pyramid's sides. The two most important elements of the project evaluation process are: (1) screening of projects that are not economically important or environmentally unfeasible; and (2) structuring projects to become financially more attractive to the private sector.

Given that BOT projects will require significant levels of effort during the project development and negotiation stages by both the Government of Slovakia and private investors, it is important that the project screening process be effective at ensuring that only projects with a high potential for success - financially, technically, legally, and environmentally - are developed. Therefore, the objectives of the BOO/BOT project screening process should be comprehensive and specific.

The objectives of the BOO/BOT project screening process in Slovakia are therefore to:

1. Determine whether there is a market for the new service. Is demand currently greater than the available supply? by how much?

2. Determine if all raw materials for the project are available and affordable. These can include cement, steel, water, steel tubing, coal, and gas.

3. Determine if the size of the project's capital cost and operating cost can be reasonably met. These include cost of materials and equipment, as well as human capital costs.

4. Determine if the current toll or tariff price for use of the existing facility or service is market-based. In some sectors of public services tariff structures need to be reformed and deregulated before private sector participation can be attracted.

5. Determine if the technology for the project is available, tested, and affordable. Projects that rely on un-tested or

expensive technologies increase the project's risks and decrease returns. Technological feasibility for each project should be determined by the project screening process.

Project Structuring. While project screening mechanisms will remain chiefly in the hands of the technical unit and specialists within Slovakia's line ministries, the BOT project structuring process will be the result of inputs from both the private and public sectors. However, it will be important that both sides of the table agree on a common set of objectives for the project structuring process.

The objectives of BOO/BOT project structuring in Slovakia are to:

(1) Initiate projects that are already economically and developmentally important for the Government and structure them to be financially more attractive to the private sector investors and operators.

(2) Produce guidelines for effectively and equitably allocating risks among all of the parties to the BOT project. These guidelines could include guidelines for arrangements and clauses to deal with concession contracts, project completion and turnkey contracts, "take or pay" arrangements and guarantees, and the establishment and operation of escrow accounts.

(3) Ensure that projects that are economically important and financially attractive are also environmentally sound.

Preparing Tendering and Bid Packages. The projects selected from the previous stages that have met or exceeded the technical units "litmus test" of project candidacy will be prepared for tendering. In this activity, the technical unit, working with the appropriate implementing agents, will plan, design, draft, structure, and package tender documents for competitive bidding.

The tendering package, typically comprised of a completed project prefeasibility study; the Invitation for Bid Proposal (IFB) which describes the standards and specifications established by government so that proposals submitted can be compared and evaluated like to like; financial and economic parameters; a legal package; environmental requirements; a model concession agreement and criteria for evaluation, is the principal instrument by which government solicits serious private sector proposals to undertake infrastructure projects.

Bid Evaluations. After bids have been received the technical unit and line agencies will evaluate eligible bids. The technical unit will need to develop the bid evaluation criterion and standards in compliance with the BOO/BOT program guidelines.

Negotiations. After the bid evaluation activity, the technical unit and relevant line agency will engage the leading bidder or bidders and begin negotiations. Negotiation activities will include not only project award terms and conditions, but, in some cases, will result in the granting of agreements such as Letters of Intent (LOI) or Memoranda of Understanding (MOU) to the successful proponent to either commence construction or to conduct full feasibility depending on the status of the project in question.

Unsolicited Proposals. One of the best methods to insure the maximum number of quality infrastructure projects are identified is to invite private sector firms to identify BOO/BOT projects and present them to Slovakia's BOO/BOT technical unit. This technique can significantly enlarge the number of project candidates that are fed into Slovakia's inventory of BOO/BOT projects.

Moreover, the private sector can also structure projects using private sector methods of financial performance incentives and risk-allocation.

Public Awareness. This activity to be undertaken by the technical unit addresses one of the most fundamental elements of any economic reform initiative: promoting an awareness of and support for private infrastructure within the bureaucracy, business sector, and general public. The component will focus on undertaking several efforts, through a variety of techniques, to disseminate information about the objectives, rationale, and benefits of public/private partnerships in infrastructure development.

The primary objective of this component is to disseminate information about the program using a variety of media, to the general public about the entire private infrastructure program.

This effort should result in a greater awareness of and support for the benefits of private infrastructure in Slovakia. The communications effort will also convey information regarding the procedures of the program so as to preempt any confusion about the entire process especially regarding the bid award and negotiation process, where potential criticism about the merit of awards is typical.

Marketing. Experience underscores the fact that without an effective marketing strategy, local and foreign investors will seek opportunities elsewhere. Additionally, attracting the maximum number of credible bids from local and foreign sources protects the long-term interests of government and the public.

The objective of this activity for the technical unit is to generate the highest number of competitive bids from the broadest, local and foreign, investor/operator, community as possible.

Currently there is no capacity to market and/or promote the private provision of infrastructure in Slovakia. The technical unit will need to address the lack of government capacity in private infrastructure promotion and marketing.

An additional constraint the technical unit will need to overcome is the relatively low level of <u>local</u> private sector capacity to participate in infrastructure project development. Currently, the local private sector does not have the market information, size, and financial stamina to undertake many projects of scale.

Marketing not only enhances the likelihood of receiving the highest number of competitive bids for projects, but also can serve as a linkage between local and foreign partners. The technical units marketing activities that will need to be undertaken should promote informational and commercial exchanges so as to ensure local and foreign collaboration in as many projects as possible.

<u>Conclusion</u>. The BOT project identification process forms the foundation of any country's BOT program "pyramid." However, project identification will not only be important in expanding the quantity of project candidates, more importantly, project identification determines the possible quality of BOT projects that can be developed.

Clearly, the techniques and strategies for structuring BOT projects are different from structuring traditional publicly-financed and operated capital projects.

What this means in the Slovakia context is that in order to guarantee that the project identification process produces a suitable quantity of BOT project candidates, Slovakia will need to include the private sector in the project identification process.

This can be reasonably attained by creating a feasibility study funding mechanism that provides partial reimbursement for the cost of privately-studied projects. In addition, Slovakia should be prepared to grant private firms limited proprietary rights to develop and structure BOT project candidates they themselves have identified and studied, as called for in the suggested Program Guidelines.

More important than expanding quantity, the project identification process in Slovakia must ensure that the inventory contains quality, viable BOT projects. To achieve this important complementary goal, Slovakia must be willing to devote significant resources to each part of the project identification and project screening process.

This includes commitments to investing in training of the technical unit and line Ministry personnel responsible for BOT projects, dedicating talented personnel to acquire hands-on experience in all aspects of project identification and screening, retaining qualified specialized consultants when necessary to study and assist in structuring BOT projects, and ensuring commitments from line Ministries to dedicate resources to the country's BOT program.

VIII. RECOMMENDATIONS AND CONCLUSIONS

As this report has stressed, the indications at the conceptual stage of Slovakia's BOO/BOT program are promising on the whole. It is recommended that the Government proceed to an initial design phase. This should encompass the following activities:

- Designating, empowering and staffing up the technical unit which will guide the design effort and undertake implementation of the BOO/BOT unit.
- Undertake more detailed infrastructure sector assessments, especially in power, telecommunications and transportation to develop a "Master List" of projects with BOO/BOT potential.
- Develop Program Guidelines for the BOO/BOT program.
- Undertake a Legal Audit to determine if there are any current impediments to BOO/BOT and how they might be overcome.
- Undertake a survey of the financial sector in Slovakia to determine its ability to support BOO/BOT projects.
- Provide training.
- Identify Requirements for Project Tendering, Award and Negotiation.
- Identify Requirements for Public Awareness and Marketing.

APPENDIX I

References

This report draws on the following reports and papers previously prepared by the author (including joint work with others as noted):

Inception Report on Privatization and Industrial Policy in Slovakia. Deloitte & Touche. Prepared for the Ministry of Economy, Bratislava, December 1992

"Securities Markets and Privatization." Working paper prepared for World Bank, in process. November 1992.

BOO/BOT Training Seminar. For officials of the Asian Development Bank, Manila, the Philippines, under contract with the Center for Financial Engineering in Development (CFED). October 13-16, 1992. With J. Martin.

"BOO and BOT Techniques in Infrastructure Development: Assessment of the Potential for a BOO/BOT Program in Bangladesh." CFED. Prepared for the Asian Development Bank. November 1992. With J. Martin and T. White.

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"The Private Sector Infrastructure Development Fund: Using Official Development Assistance for BOT and Privatization Projects." Prepared for the Office of the President of the Philippines, Manila, February 1992.

"Financing BOT Projects in the Philippines." Prepared for the Office of the President of the Philippines, September 1991.

"Privatization and Capital Markets in Developing Countries." Paper presented to the World Bank. January 28, 1991.

<u>Privatization in Thailand</u>. Prepared for the Center for Privatization and the Ministry of Finance, Bangkok, Thailand. November 1990. With R. Downer, R. Samuelson, D. Levintow, et. al.

Michael P. McLindon
February 1993
Bratislava, Slovakia

March 8, 1993

Mr. Marian Jezek
Vice Minister
Chief of Chemical and Pharmaceutic Industries Division
Ministry of Economy
Bratislava

Dear Mr. Jezek:

As you may remember, we had the chance to meet a few weeks ago to discuss privatization options for the chemical industry in Slovakia. At the time, we discussed the possibility of a technical unit to help you and the Ministry to develop privatization options and strategies. Attached is a short paper (based on my previous experience with this in a number of countries) on how a technical unit might be set up to assist in this task.

I look forward to discussing this at your convenience.

Sincerely,

Michael P. McLindon

A TECHNICAL UNIT FOR STANDARD PRIVATIZATIONS
FOR THE MINISTRY OF ECONOMY

Michael P. McLindon

March 1993

Bratislava

A TECHNICAL UNIT FOR STANDARD PRIVATIZATIONS

Introduction. As a part of the ad hoc advisory services provided under Delivery Order No. 15, the Minister of Economy, Ludovit Cernak, requested the advisor (Michael McLindon) to assist in the further development of the Ministry's paper on industrial policy. This was completed by the advisor as an "inception report" in late December 1992.

After reviewing a draft document, the advisor recommended that the government adopt an "enabling" rather than an "interventionist" approach to industrial policy. This would entail the government's provision and facilitation of the economic, legal, marketing and related needs to foster the proper environment for industry and commerce to develop. The recommended specific elements of industrial policy included continued privatization as a primary instrument of restructuring, promotion of foreign investment, an export orientation, the development of capital markets, and facilitation of the private provision of economic infrastructure.

As a part of its industrial policy, the Ministry of Economy continues to assign primary importance to privatization as the basic instrument of restructuring.

Slovakia's Approach to Privatization. The Government of Slovakia has taken a policy decision to de-emphasize the coupon approach to privatization adopted by the Czech Republic. Although Slovakia will use the coupon method under certain circumstances, it will rely more on "standard" privatizations, including public tenders and share offers.

Under the current system of privatization in Slovakia, the management of the individual SOEs are charged with preparing privatization plans, which are then discussed and finalized with the founding ministries. For commercial and industrial enterprises, the founding ministry is generally the Ministry of Economy. The final plan is approved by the Ministry of Privatization.

Thus, the individual SOEs and the Ministry are responsible deciding upon a number of key factors, including structuring the privatization, and assessing sources of financing. In response to a need expressed by one of the departments (chemicals) in the MOE for assistance in structuring privatizations, it was proposed that a technical unit would be helpful in providing advice on optimal ways of carrying out privatizations. Given that the number of remaining companies to be privatized in this sector is relatively small, the technical unit could process other sectors which fall under the MOE's field of responsibility.

The Technical Unit for Privatization. A technical unit to process a large number of SOEs is a fairly common approach for countries following a "standard" approach to privatization. It has worked well in other countries.

The key elements and activities of this technical unit would include:

--Public education and awareness of the privatization campaign.

--Staffing, operations, training, and office equipment for the MOE.

--Technical assistance from local and foreign financial and privatization expertise to analyze privatization possibilities and methods.

--Accounting, audits, valuations, company profiles, marketing and advertising, and legal work associated with public tenders and share offers, and other forms of privatization.

--Analysis of means to promote further Slovak participation in the privatization process.

<u>Staffing</u>. The key to ensure the relative smooth flow of operations is staffing.

The staff will also need a structured training program. An outline of such a training program is given below.

The technical unit would be a core group which would be supplemented as required by outside specialists. The technical unit's work will be to identify candidates for privatization, gather information about the public enterprises to be privatized, identify means to overcome constraints to completing the transaction, work with the valuators, finalize recommendations on the appropriate modality for privatization, oversee the preparation of the profile for investors, complete the tender packages, evaluate proposals and negotiate with applicants and other parties, present recommendations for award, and close the transaction.

In order to maximize the value of transactions for the government, the technical unit should attempt to solicit a large number of competitive offers from applicants. To negotiate effectively, the team must have, among other things, sufficient knowledge of the enterprise and the industry in which it operates. Technical units designed along the lines recommended have worked well in other countries.

The goal of the Slovak staff within the MOE should be to develop the capacity to manage the process of privatization and complete transactions.

It is not necessary to develop the in-house capacity for all of the skills required in privatization. It would be more cost and time effective to contract out much of the technical professional services to local and/or international firms.

An appropriate staffing pattern for the MOE technical unit would follow the following lines:

Slovak Professionals:

Chief Executive. He will have policy and administrative oversight of the technical unit. He would report to the Minister of Economy.

Manager. The manager would serve as a deputy to the chief executive, and be responsible for many of the day to day operational matters.

Financial Analysts/Accountant. A core of experienced financial analysts and/or qualified accountants would be needed to gather information about the enterprises and compile projections on the potential of the enterprises. Much of this work can be contracted to outside firms, but it would be important to have full time talent working within the technical unit.

It is not expected that these individuals would possess the skills to undertake valuations, or produce audited financial statements. However, they should be generally conversant in these fields and be able to liaise and interact as project managers with the firms chosen to provide these professional services.

These persons must be capable of utilizing word-processing and spreadsheet packages. They should be organized into enterprise teams with a leader or assigned individually to deal with enterprises, depending on the complexity of the transactions. In the first year, it is recommended that twelve people possessing skills comparable to the above be recruited for the technical unit. More should be added depending on the speed with which the second wave of the privatizations unfold.

These Slovak staff members should also receive training, and they will also acquire valuable on the job training from working under the Chief Executive.

Legal Adviser. Much of the legal work related to specific transactions should be contracted out to Slovak and/or international law firms. In view of the multiple privatizations that may be carried on by the unit at any time, there should be a full-time commercial attorney available and qualified to practice in Slovakia to work full time with the technical unit. He would liaise with the law firm hired on subcontract to provide legal services. His work objectives would be set by the Chief Executive.

Foreign Advisors.

As privatization begins in earnest it will be helpful, indeed critical, to have the expertise of those who have had exposure to privatization transactions in other countries, and who are aware to the pitfalls that can delay or even derail a privatization program.

Privatization Adviser. The Privatization Adviser would advise the Chief Executive as to the preferred mode of privatization for the individual enterprises and present alternatives. He will set out the procedures to be followed by the technical unit for each entity approved for privatization, which will include the generic and specific procedures relating to the enterprise. He will also determine the skills needed for the completion of the tasks, and assist the Chief Executive in hiring a full time technical unit manager during the first year of the project.

The Privatization Adviser will visit Slovakia when necessary to review the work of the teams, plan for work to be done for additional enterprises and advise on the conduct of negotiations. He will hold seminars and workshops with technical staff to explain the objectives and methodology relating to the tasks.

In addition to his visits to Bratislava, the Privatization Adviser will be available for telephone and fax consultation while not in Bratislava. In the event that there is a public share offer, his presence will be needed for extended periods in Slovakia.

Ideally, the Privatization Adviser will have been responsible for the planning of a successful privatization program and have designed and been in charge of the completion of privatization transactions, including public relations and advertizing.

Manager. There should be a full-time Manager in the technical unit. The manager will report to the Chief Executive and the Privatization Adviser. Experienced in the management of contracts, the Manager will have a broad range of experience in finance and transaction development, and in presentations to potential investors and government officials. He will possess strong negotiating skills. Initially, a foreign advisor should fill this position, perhaps for the first year or two. A Slovak counterpart should be identified early and be given training so that he or she could assume this position. If the privatization program successfully takes off, it may prove useful to recruit additional managers.

Financial Analyst. There should be a financial analyst in the technical unit. He would report to the Privatization Advisor. He would work closely with the Slovak financial analysts and accountants to analyze parastatals for privatization, and help to determine the most appropriate mode. He would spend one year in Slovakia.

Ad-hoc short-term consultants. It will be important to build flexibility in the technical unit in order to provide needed assistance to meet needs that arise earlier than planned, or to meet unforseen needs. Part of the effort of the technical unit will require foreign and local ad-hoc consultants. These will include industry specialists and other experts as required. It will be particularly important to have person(s) skilled in marketing and public relations working with the technical unit. This work could be initially undertaken for six months by a foreign expert.

It will be important to have the following services available:

Valuations, company profiles and marketing. The valuations would consist of going concern valuations, and other valuation approaches as specific circumstances warrant.

In the process of preparing valuations, the subcontractor would have gathered a good deal of information about the enterprise. This knowledge should then be put to use in developing company profiles for enterprises to be tendered.

Finally, because of international connections, the firm would be in a suitable position to place advertisements, make contacts and help to market the enterprise that is being put up for sale. The objective would be to generate as many competitive offers for the enterprise as possible.

The importance of marketing to the transparency and success of the program cannot be over emphasized. This will be especially true in a country such as Slovakia, where insufficient attention has been placed on marketing skills in the past during a long period of a government-dominated approach to economic development.

Marketing can be specifically improved by focused advertising of "Invitations to Prequalify and Bid" to generate a large number of bids, and by giving sufficient lead-time and advance notice of the tendering process. The technical unit could identify newspapers, trade magazines and journals that would be appropriate for the advertisement of the sale of specific companies. They could also distribute company profiles widely through various investor networks.

This would enable prospective intermediaries to provide advance notice to prospective buyers. Foreign investors especially must have sufficient time to put together serious bids based on the information in the company profiles, company visits and interviews, due diligence activities, and professional consultation. The technical unit will need to ensure that suitable, up-to-date financial information is provided to potential investors. Access to companies and contact with current management will need to be coordinated. Evaluation criteria should be specified in the tender document, and the relative importance of these criteria indicated.

Legal Advisor. A top ranking law firm in Slovakia should be retained to provide transaction related legal advice. The law firm would work on the following tasks:

- Arrange for the preparation of the memorandum and articles of association or any special incorporating statute for the public enterprise to be privatized.

- Obtain copies of all important agreements, including loan agreements, encumbrances of assets, leases, clear title to land, confiscation orders, construction contracts in progress, union agreements, licenses, authorization for incentives and any special legislation applicable to the enterprise.

- Summarize important or unusual features and exposure to litigation for any of the above for the enterprise and its business operations.

- Review tender documents and prospectuses to ensure conformity with applicable laws

Training and Public Awareness. A foreign firm with experience in providing training programs in privatization (and related areas such as capital markets) should be utilized to provide training for the MOE, and public and private sector officials.

Members of the MOE technical unit will be the focus of the training effort. General areas where the staff include privatization strategies and techniques employed in other countries, and how they can be adapted to Slovakia. Specific areas required by the technical unit are financial analysis, valuation techniques, the operations of stock markets, an appreciation of the criteria used by investors in deciding whether to invest or not, experience in negotiations, and familiarity with commercial law and contract law.

As the valuations of state enterprises will be especially important, it is recommended that detailed training be given in this area early on. Approaches to valuation should also be stressed in the general one day seminars for government and private sector officials. While it is recommended that valuations be contracted out, it will be important for members of the technical unit to have a sophisticated understanding of valuation.

A Public Awareness Program. It will be important to continue the campaign to increase the public's awareness of the benefits of privatization and the techniques employed and success achieved in other countries.

A series of seminars, such as "Why Privatize," "How to Privatize," "Financial Markets Development," "The Benefits of Share Ownership," and "Employee-Management Leveraged Buyouts," need to be developed in coordination with the technical unit. They would be targeted for the critical groups, such as government officials, union leaders and rank and file, SOE management, and the private sector.

These series of seminars would not only contribute to the public awareness campaign, but would also help define objectives, develop strategies, and reinforce the will to privatize. It will also increase transparency.

References

This memo draws on the following reports and papers previously prepared by the author (including joint work with others as noted):

Privatization in Thailand. Prepared for the Center for Privatization and the Ministry of Finance, Bangkok, Thailand. November 1990. With Richard Downer, Richard Samuelson, David Levintow, et. al.

"Selling Thailand Inc." _Far Eastern Economic Review_. June 20, 1991. With Richard Samuelson.

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Michael P. McLindon
March 1993
Bratislava

February 12, 1993

Ms. Jana Karelova
Department of Foreign Investment
Ministry of Economy
Spiltanska 8
Bratislava, Slovakia

Dear Mrs. Karelova:

Thank you for your invitation to attend the meeting on February 9, 1993 with Ms. Ellen Lederman of the IFC and Mr. Boris Velic of the FIAS/IFC to discuss foreign direct investment in Slovakia.

This letter is written in response to your request for an opinion in respect of sending a written request to the Foreign Investment Advisory Services (FIAS) for them to undertake a diagnostic study of the needs and requirements for foreign investment in Slovakia. I believe that this would be an appropriate step to take at this point.

I think that it would also be useful for the Government of Slovakia to reach an agreement with MIGA. It was also be useful to develop a longer term project to establish the requisite infrastructure in Slovakia to attract and facilitate foreign investments in Slovakia.

As I may have mentioned, Minister Cernak has asked me to prepare a memo on the main points of direct foreign investment policy. Attached is a rough draft outline of some of the key issues. (As a draft, this outline is of course incomplete.) I would welcome the opportunity to discuss these points with you next week.

Again, thank you for the opportunity to participate in the meeting earlier this week.

Sincerely,

Michael P. McLindon
Advisor

Dipl. Ing. Ludovit Cernak, CSc.
Minister
Ministry of Economy of the Slovak Republic
Mierova 19
Bratislava

February 17, 1993

Dear Mr. Minister:

Following your request, I have outlined some of the main issues that exist with respect to foreign direct investment, which are attached for your information.

I also had the opportunity to attend a meeting held by Ms. Jana Karelova on February 9, 1993, with Ms. Ellen Lederman of the IFC and Mr. Boris Velic of the FIAS/IFC to discuss foreign direct investment in Slovakia.

As a result of this meeting, it appears that it would be advantageous for the Ministry of Economy to request the Foreign Investment Advisory Services (FIAS) for them to undertake a diagnostic study of the needs and requirements for foreign investment in Slovakia. Ms. Karelova will be sending you a formal letter with more information on this later in the week.

It would be useful for the Government of Slovakia to reach an agreement with MIGA.

Sincerely,

Michael P. McLindon

DIRECT FOREIGN INVESTMENT (DFI)

Role of DFI in Slovakia:

- Catalyst to transform Slovakia's economy into a market economy and attain international competitiveness.
- Help to facilitate the transfer of technology, capital, market access and management resources to Slovakia.

Attractions of Slovakia:

- A skilled, well educated work force.
- Geographical location at the crossroads of Europe
- A desire to promote local and foreign private sector investment.
- Growing reputation as an attractive investment location, based on reasonable labor costs.
- Commitment by the Government to promote private enterprise and market-oriented approaches to economic development.
- An economy with tremendous upside potential for business over the long run once economic reform takes root.

Activities to Promote DFI:

- Have FIAS conduct a diagnostic study
- Take steps for Slovakia to reach agreement with MIGA.
- Develop longer term project to establish the requisite infrastructure in Slovakia to attract and facilitate foreign investments in Slovakia.

Institutional and Policy Setting

- Needs some clarification: respective roles of SNAFID (as agency of MOP) and MOE.
- Institutional Roles Corresponding to Types of FDI: Purchase of companies being privatized (role of Fund of National

Properties); Additional foreign investment in existing (privatized) companies; FDI for newly created enterprises; FDI in BOT type infrastructure projects.

- Need for separate MOE agency to promote new FDI and BOT related FDI?

- Equal treatment of national and foreign investors--limited use of tax holidays. (However, current corporate and personal income taxes are high and not competitive with other countries.)

- Industrial parks constructed and managed to extent possible by private sector, rather than special economic zones

- Policies affecting foreign portfolio investment (i.e. non-controlling interest) also important to consider

Ways to Improve Process of DFI:

- Identify institutional responsibilities for DFI.

- Try to avoid approval on a case by case basis as much as possible. This delays investment decisions, but seldom gives authorities the desired control.

- Use "negative list" which identify activities which are not welcome. Publish activities that are permitted only upon government approval. Stated that activities not on either list will be open to DFI without government approval.

- Streamlining of related activities: currently takes too long to set up a company in Slovakia (4-5 months).

Ing. Jaroslav Kubecka
Minister
Ministry of Economy of the Slovak Republic
Mierova 19
827 15 Bratislava

April 16, 1993

Subject: Memo on Trade Policy

Dear Mr. Minister:

I am pleased to be able to enclose a memo on Slovakia's trade policy for your consideration.

I would be pleased to discuss this further with you at your convenience.

Sincerely,

Michael P. McLindon
Advisor

TRADE POLICY FOR SLOVAKIA

Introduction and Summary. In view of the relatively small size of Slovakia's domestic market (5.3 million people) it will be important to establish an outward looking, export oriented trade policy in order to realize economies of scale and scope, and enable trade to become an engine of growth.

The following points will be important for Slovakia's trade policy:

- Exchange rate policy. A flexible exchange rate will be required.
- Tariff structure. The inherited tariff structure was low and relatively flat. This should be continued.
- New trade agreements. Slovakia should set a goal of attaining EC membership by at least the year 2000.
- Trade promotion. An export promotion agency would be useful. Tourism would lend itself particularly well to promotion abroad.

Previous Trade Strategy. Under central planning before 1989 in the former Czechoslovakia, foreign trade was not an engine of growth, although it made up a large part of the economy. Exports basically served to finance imports. The purpose of imports was largely to complement production, rather than compete with domestic goods.

Before 1989, tariff protection was low and the tariff schedule relatively flat. However, there was still a high level of protection resulting from non-tariff barriers, such as foreign exchange controls, and import-export monopolies.

A New Strategy.

A pro-growth trade policy will require efforts on several related fronts.

Exchange Rate Policy. A competitive exchange rate is key to realizing the advantages of trade. Under current conditions in Slovakia, a devaluation would have twin benefits for the balance of payments. A devaluation will help the balance of payments by increasing the price of imports (which will reduce their quantity), and increasing the price received for exports, which will serve as an incentive to domestic producers to increase their level. Following a devaluation, it will be important for the government to decide upon a flexible exchange rate mechanism.

Tariff Policy. The existing tariff is a good starting point for a new trade orientation. As noted, a uniform and low tariff coupled with a flexible exchange rate mechanism are the best instruments for achieving a dynamic trade sector. Before independence, tariff protection was low and the schedule relatively flat. As a result, effective protection rates were low. (There was a narrow range of extremely high effective protection rates. Protected industries include food canning, textiles and clothing, pulp and paper, synthetic products and motor vehicles.)

With the change from the previously high protection from non-tariff barriers, to the low level of protection under the tariff schedule, demands could be made to increase the existing tariff rates.

However, higher tariffs would be costly to the economy, and contribute to inflation. Restricted imports, especially of machinery and other capital goods, would delay the process of industrial restructuring and export expansion. Slovakia will need new technology and machinery and equipment, which will be largely imported, to gear up for exports to, and eventual membership in, the European Community.

It is understood that the government is currently undertaking a review of "non-essential" consumer items with a view to levying higher tariffs on them. This runs counter to a "low and level" tariff structure, and should be discouraged. Exchange rate adjustments are a better tool for allocation of imported goods and foreign exchange.

Trade Agreements and the European Community. Despite some trade barriers, Slovakia should find it advantageous to orient its trade increasingly to the west. At the same time, it should maintain its remaining viable eastern markets.

Previously, foreign trade was characterized by bilateral trade agreements. These factors, and the territorial and product orientation forced upon the country, have tended to suppress the level of foreign trade.

A free trade agreement among Slovakia, the Czech Republic, Hungary and Poland would reduce duties on industrial and agricultural goods by 2001, and should prove useful in expanding markets.

Slovakia, Hungary, Poland and the Czech Republic, also want to be full members of the European Community by 2000, with final negotiations to start by 1996.

In 1991, the EC signed the "Europe Agreements" which provide for associate member status. However, the Europe agreements have not attempted to create conditions for full membership. Under the agreements, 40 percent of exports are subject to some form of trade restraint, which is a significant proportion. Steel exports, for example, face a 30% tariff, which the EC wants to raise.

Assuming that Slovakia is able to develop and implement an economic policy that allows it to maintain basic macroeconomic stability, while realizing structural adjustment through privatization and other means, attaining full membership by the year 2000 should be a realistic goal.

The basic indicators of ability to satisfy EC obligations are the "Maastricht criteria," the guidelines that countries are supposed to meet if they are to use the future common European currency. The Maastricht criteria include the following:

- The government budget deficit 3% of GDP or less.
- Total debt less than 60% of GDP.
- Inflation: less than 0.3% month-on-month change.
- Long term interest rates: less than 10.6%

The Maastricht criteria are just guidelines, not automatic qualification procedures. Nevertheless, applying them to Slovakia, Poland, Hungary, and the Czech Republic produces the surprising conclusion, as the Economist has noted, that these countries are readier for membership than some current members. It will not be long before Hungary, Poland and the Czech Republic and Slovakia are where Greece and Portugal were on entry.

Export Promotion. Experience in other countries in Asia and Latin America has demonstrated that there is a high return to setting up an organization to promote a country's foreign trade. An organization which can actively promote Slovakia's exports will be an important part of trade strategy.

Tourism can be considered as a part of the export orientation. Slovakia clearly has tourist potential. At the same time, there is a large western market looking for new tourist destinations. Much of tourism development will depend on the development of general economic infrastructure by the private sector as discussed below, but marketing and advertising of Slovakia as a tourist destination is a area that can benefit from government support.

Infrastructure. In order to expand exports of goods and services rapidly, Slovakia needs to improve its economic infrastructure, especially telecommunications, as quickly as possible.

However, the costs of infrastructure are very high, and the government must restrain expenditures in order to reduce the deficit and try to maintain macroeconomic stability. Means of enabling the private sector to supply most economic infrastructure have been developed in amy other countries using the Build-Own-Operate and Build-Operate-Transfer methods. It will be important for Slovakia to develop a similar mechanism in view of its infrastructure needs.

Realizing a dynamic trade policy will not only require a reorientation of trade flows, but also basic industrial restructuring. Privatization and restructuring by the private sector will help firms in Slovakia to determine their competitive advantage and ability to export.

References:

The World Bank, "Czechoslovakia: Transition to a Market Economy." 1991

The Economist, "Eastern Europe: The Old World's New World." March 13, 1993

Michael P. McLindon
April 1993
Bratislava

Mr. Josef Petras, Director
Financial Division
Ministry of Economy
Bratislava

May 17, 1993

Dear Mr. Petras:

I am pleased to attach a copy of a memo on inter-enterprise arrears in Slovakia. I have completed this at the request of Minister Kubecka and yourself. It is intended to help in the further development of a solution to the problem of inter-enterprise arrears, and specifically to help the Ministry and USAID identify the next steps in the possible provision of technical assistance by USAID.

It has been a pleasure to work with you and your staff, and I would like to wish you the best in your endeavours.

Sincerely,

Michael P. McLindon

Memo on Inter-Enterprise Arrears

Introduction.

The Ministry of Economy has requested technical assistance from USAID for approximately 150 days to analyze means of dealing with the problem of inter-enterprise arrears that exist among firms in Slovakia.

Minister Kubecka also requested the advisor, as a part of the ad hoc advisory work, to spend some of the remaining time to do an initial analysis of the problem.

This memo has been based on a limited sample of firms and financial institutions which the advisor was able to interview, or to read selected documents about. As a result, this memo serves only as an introduction to the problem of inter-enterprise arrears, and is intended to be of assistance should USAID and the Ministry decide to undertake this larger task.

Nature of Problem.

The Government of Slovakia has identified the high level of arrears, and corresponding illiquidity, that currently exist among enterprises, as one of the key economic problems in Slovakia.

The origin and nature of the problem is complex, but is related to the loss of leading export markets (e.g. in the defense industries), the failure of former CMEA partners to pay their bills owed to Slovak firms, and the temporary decline in economic activity that has accompanied the shift to a market system.

Many enterprises relied heavily on markets of the former Soviet Union (FSU), which effectively disappeared in the last three years. A large part of (now lost) exports to the FSU were military hardware. Apparently, many Slovak firms have continued to produce goods for markets which currently do not exist. As a result, their inventories of finished goods are high and cash balances low.

As export businesses lost their markets, and were left with bad debts of FSU and other customers, their suppliers in turn could not be paid. Their suppliers, who either because of established relationships and/or poor credit risk assessment, continued to supply these firms. The suppliers as a result have high levels of accounts receivable and little cash.

The Government refers to latter situation as one of "secondary insolvency" and views the suppliers as generally viable firms that are being injured by the "primary insolvency" of the larger firms which have lost markets but continue to produce.

In addition, many enterprises have borrowed money from banks, but are unable to service their debt. This has led to a deterioration in the banks' balance sheets and an inability to provide new credit to even worthy enterprises.

Analysis.

Inter-enterprise arrears has to be viewed in the context of the overall financial position of a company. By itself, it focuses too closely on two accounts--accounts receivable and accounts payable--and may miss the overall flow of cash in an enterprise. Correcting the problem of inter-enterprise arrears is one part of the overall restructuring of industries that is required in Slovakia.

Overview of Enterprises in Slovakia. The Ministry of Economy (MOE) has developed a data base of financial information on enterprises for which it is responsible, as well as companies which are in the portfolio of the Fund for National Property (FNP), which generally includes those companies which have been corporatized and are awaiting the implementation of privatization plans by the FNP. (Neither the advisor nor Deloitte & Touche have independently reviewed this data base, and accordingly make no representation about its accuracy or completeness.)

The Ministry of Economy has 419 enterprises in its portfolio. In addition, there are another 78 state enterprises which are in the process of liquidation, and which are not included in the data base. The Fund of National Property has 316 companies in its portfolio. Table 1 indicates that for both the FNP and MOE, two-thirds of the companies are profitable.

Table 1

	FNP	MOE
Number of Companies	316	419
Of which, profitable	210	276
Percent Profitable	66%	66%

Source: MOE

Of course, the companies that are "profitable" are those which are profitable under the accounting regulations for the former Czechoslovakia in 1992. Under these regulations, certain fundamental Western concepts are not applied, namely:

- Matching of costs and revenues,
- Assumption of going concern,
- Accrual basis of accounting,
- Profits included only when realized,
- Foreseeable liabilities and losses are reported, and
- Accounting princliples are applied with prudence.

In addition, historical costs, expenses and revenues were controlled by the government and/or subsidized, and were not necessarily indicative of free-market or world prices of goods and services.

The indicators for liquidity in Table 2 capture the cash starved position of most enterprises in the FNP and MOE portfolio. (These figures appear to be unweighted averages.) Cash ratios are particularly low for these companies.

Table 2

Liquidity

	FNP	MOE
Current Ratio	1.248	1.357
Acid-Test Ratio	0.328	0.371
Cash Ratio	0.119	0.108

Source: MOE

Table 3 points to the difficulties with and poor management of inventory and accounts receivable and payable, where much of the enterprises' cash is tied up.

Table 3

Turnover Ratios
(days)

	FNP	MOE
Inventory	240	141
Accounts Receivable	162	122
Accounts Payable	372	247

Source: MOE

The high inventory level is a probably a reflection, in part, of the well-know practice of stockpiling which is a leftover from the central planned economy, when delivery of needed inputs was uncertain. The inventory levels also reflect the fact that much useless or obsolete inventory continues to be carried on the books.

The high levels of receivables is in part a reflection of accounting principles. For example, under existing accounting and tax regulations, enterprises are unable to establish a reserve for actual and potential doubtful accounts.

Many trade receivable are also recorded manually, and therefore it is difficult to produce a proper aging of receivables.

A high level of receivables and payables also reflects the lack of experience with undertaking a check on the credit worthiness of a customer. Many enterprises do not evaluate the credit worthiness of new customers before deciding to sell to the customer. Only existing customers are reviewed. It also reflects the difficulty of obtaining background credit checks as to the credit-worthiness of a company's major domestic customers (i.e. ability of the customer to pay debts timely, the amount of outstanding debts, etc.)

More fundamentally, though, the buildup of payables and receivables by companies points to present financial realities in Slovakia.

Under Czechoslovakia accounting practices, all invoices must be paid within 14 days upon receipt of invoices unless a separate contract exists. Czechoslovakia law allowed companies to charge interest on past due invoices, referred to as interest penalties. The penalties apply for invoices not paid within 14 days from receipt of customer invoice, or, if a separate contract exists, after the contracted term.

The amount of these interest penalties can be identified in the customers contract or, if not specifically identified, a standard rate of 18.5 percent annually is charged. (The penalties or late fees are chargeable at the discretion of the supplier and are not required to be charged.) Under local accounting practices neither the supplier or the customer records these charges until the penalty is actually paid and cash is received. At that time, the revenue or expense is recognized.

In view of the present financial situation in Slovakia, a build-up of payables is the cheapest and often only source of financing. Credit from banks is scarce even for viable enterprises. Interest rates from banks are often 25 percent and higher. By contrast, simply electing not to pay a payable has the effect of securing a loan at a fairly low rate of interest--18.5 percent. Thus, as a short term response in the present financial setting, building up payables is a rational response. Obviously, though, the window of time in which an enterprise can avail itself of this particular form of financing is fairly short and limited by the patience and financial stamina of their suppliers.

Interestingly, however, there is little evidence of general or widespread insolvency (as opposed to illiquidity) among the firms in the portfolio of the Ministry of Economy or the Fund for National Property. While the overall ratio of liabilities to equity could be improved, the average ratios observed for the FNP and the MOE are not particularly bad.

Table 4

Solvency

	FNP	MOE
Long Term Liabilities/Equity	.15	.21
Total Liabilities/Equity	1.8	1.7

Source: MOE

Of course, these numbers can only be taken as rough indicators of the financial realities facing these firms, since these figures have not been provided accorded to generally accepted accounting principles, and other data problems alluded to above. (Also, the exact definition and translation of terms is not clear in some cases.)

Nevertheless, the picture that the data present is one of companies facing severe cash flow problems on account of build-ups of inventories and account receivable. The long term solvency position of the MOE and FNP enterprises appears to be less dire. This points to the possibilities, and existence of manoeuvreing room, for restructuring, which is ultimately the answer to inter-enterprise arrears and related problems.

Solutions. The available financial records and empirical evidence indicate that there are many Slovak firms that are competitive or have the potential to be competitive.

The challenge for the government is to find some mechanism to assist these firms during a liquidity crisis. It must do so while avoiding subsidies to enterprises, or creating general credit vehicles to enterprises which would erode hard budget constraints, and lead to erosion of fiscal and monetary restraint at the macroeconomic level.

Redressing the problem of inventories and accounts receivable is one part of the overall restructuring of industries that is required.

The restructuring measures available to enterprises include short-term adjustments, such as:

- Trying to maintain liquidity by selling assets, reducing labor, and stopping some production lines.
- Maintaining and recovering markets and main sources of inputs
- Focusing on core businesses
- Developing longer term restructuring plans.

The longer term restructuring actions can include:

- Financial restructuring
- Downsizing
- Changing/improving management
- Reorganization
- Focus on key product lines
- Efficiency improvement
- Investments to improve and expand operations

A complementary part of the restructuring effort will be the implemention of the new bankruptcy law to shut down nonviable enterprises.

The key prerequisite to undertaking restructuring, in turn, is to privatized the enterprises. While successful restructuring can be designed while the enterprise remains under state ownership, as a practical matter, there are few if any successful cases where restructuring has actually been fully implemented. Thus, it will behoove Slovakia to privatize the remaining state owned enterprises as quickly as possible.

Fortunately, the situation in Slovakia with respect to inter-enterprise arrears and restructuring is not static. Managers have already begun the process of restructuring. One basic restructuring strategy is to split enterprises into their viable and non-viable parts. While problems remain, including inter-enterprise arrears and banks loans in the non-viable parts, at least they are isolated from the viable parts.

A limited set of interviews suggests that managers are also watching inventory and accounts receivable very closely. Many are selling goods only with a down payment or on a cash basis.

Some financial institutions are apparently beginning to factor receivables. This market driven process involves a third party buying the receivables at a discount. The discount rate is likely to be large initially large. However, over time, as experience with the market is gained, the discount rate can be expected to decline.

Another mechanism may be to use debt/equity swaps among firms. Companies could agree to swap some of their accounts receivable for equity in the firm which owes them the money. These shares could be held as an investment, or, if liquidity were a problem, sold through the Bratislava Stock Exchange.

A few years ago, marketing skills and marketing departments in individual enterprises were unknown in Slovakia. Now the marketing departments are by necessity coming into existence and occupying the place in corporate decision making. Further, they are going out and beginning to enter much needed foreign markets.

Clearly, the present situation is an incentive to export. With local markets depressed, and limited buying power of Slovak consumers, enterprises have an excellent incentive to find foreign markets. This is itself a very viable solution the inter-enterprise problem. As firms receive hard currency for their exports, they can begin to pay down their liabilities, including accounts payable and bank loans. Ensuring a competitive exchange rate is important to provide the proper market incentive to exports.

It could be argued that the government should make these loans or credits available to enterprises with export potential. However, it would be much preferable for the commercial banks to undertake this on a commercial basis.

If the government wants to provide financing to enterprises, a simple and efficient means exists to do that almost immediately: lower the corporate tax rate. Rates are still fairly high at present (in comparison with other countries--see Table 5). This lowers possible level of retained earnings which would go into productive investment, and reduces dividend payouts which will deter share investors, thereby lowering share price and making it more expensive to raise equity financing.

Table 5

Statutory Corporate Income Tax Rate

Slovakia	45%
Poland	40%
Hungary	40%
USA	38%

Source: IFC

The EBRD has made a proposal to the Government of Slovakia to investigate the feasibility to setting up a turnaround fund. The objectives of this fund would be to take control of 20-30 enterprises; restructure their balance sheet through the injection of cash and reconciliation of liabilities with the banks and trade creditors; turn around the operations through a combination of cost cutting, product rationalization and sales/marketing actions; and realize the value by selling to private investors, industrial companies, the public or the employees. This proposal appears to be good idea. Of course, by itself it won't solve the myriad problems facing enterprises alone, but it would at least take 20-30 companies off the governments hands, and could have a very positive demonstration effect.

Next Steps.

During the next few months, the MOE and the Government of Slovakia will be reviewing a number of different proposals to deal with the problem of inter-enterprise arrears.

Additional analysis is required to ascertain the current situation of enterprises. It would be helpful to have technical assistance to work with the MOE and related ministries and agencies to try to identify the approach that is most consistent with long run economic stabilization and growth. The danger exists that subsidies or credit facilities may be presented as "rescue operations" for illiquid enterprises which in essence would reintroduce the soft budget constraints, with potentially disastrous implications for overall fiscal and monetary policy.

The aim of any rescue operation should be guided to privatization and restructuring. Since the current emphasis of the government of Slovakia is on standard privatization, the technical assistance could use the data and information gathered to help the Ministry of Economy to develop a strategy for proceeding with the privatization of the remaining 419 MOE enterprises.

Unfortunately, the experience of standard privatizations in other countries indicates that this is a generally a slow process. Should this occur in Slovakia, then the government would be well advised to consider re-introducing coupon privatization, which works comparatively quickly.

Terms of Reference for an Analysis of Inter-Enterprise Arrears in Slovakia

Request for Assistance. The Ministry of Economy requests approximately 90 days of technical assistance to help the Ministry of Economy (MOE) to develop a solution to the pressing problem of inter-enterprise arrears ("secondary illiquidity") in Slovakia.

Background. The Government of Slovakia has identified the high level of arrears, and corresponding illiquidity, that currently exist among enterprises as one of the key economic problems and constraints to growth in Slovakia.

The origin and current nature of the problem is complex, but is related to the loss of leading export markets (e.g. in the defense industries), the failure of former CMEA partners to pay their bills owed to Slovak firms, and the temporary decline in economic activity that has accompanied the shift to a market system.

According to MOE personnel, many firms have continued to produce goods for which markets currently do not exist. As a result, their inventories of finished goods are high and cash balances low. Their suppliers, who either because of established relationships and/or poor credit risk assessment, have continued to supply these firms, which cannot pay them. The suppliers as a result have high levels of accounts receivable and little cash. The Government refers to this situation as on of "secondary illiquidity" or "secondary insolvency," and views the suppliers as generally viable firms that are being injured by the "primary illiquidity" of the larger firms which have lost markets but continue to produce.

In addition, many enterprises have borrowed money from banks, but are unable to service their debt. This has lead to a deterioration the banks' balance sheets and an inability to provide new credit to even worthy enterprises.

Scope of Work.

1. Examine financial data available on firms from available sources, such as the Ministry of Economy and the Fund of National Property. Determine to what extent data is sufficient for analyzing problem of inter-enterprise arrears. Make recommendations on how to improve nature and presentation of data.

2. Develop a method, based on criteria to be elaborated, which would help to distinguish between illiquid (those which are viable in the long run, but face current cash difficulties) and insolvent (are not viable in the long run) firms.

For these categories of enterprises, a preliminary diagnosis would be undertaken to determine the nature of the enterprises' problems, and develop a range of possible alternative courses of action to assist or restructure the enterprises.

Further, the implications of findings for the related problems of financial reforms, especially of the banking system, as well as current efforts to develop a suitable bankruptcy law, would be assessed.

3. In undertaking the analysis and developing recommendations, the consultant would work closely with the Ministry of Finance, the Fund of National Property, the Ministry of Privatization, the newly established Slovak National Bank and other relevant ministries and agencies to develop an approach that has broad support within government.

4. Develop recommendations with a view to the World Bank's efforts and probable development of a sectoral adjustment loan to help resolve the problems of inter-enterprise arrears and related stresses on the financial system.

5. In view of the uncertain nature of the availability and accuracy of data on enterprises, as well as the anticipated development of a long-term loan from the World Bank to commit substantial resources to this problem, it is not anticipated that this assignment will be able to solve the issue of inter enterprise arrears, or even answer definitively the issues raised in items 1-4. However, it should be able to advance the analysis of the problem, and elaborate terms of reference for any follow-up studies which may be required, and make a time-table for actions, studies and any other activities proposed.

Deliverables. The deliverable under this part of Delivery Order No. 15 will be a report outlining steps taken towards solving the probler of inter-enterprise arrears, as well as the next steps to take in the process.

Qualifications. The consultant(s) chosen to undertake this task should be financial analyst(s) with experience in working with companies that are facing financial difficulties. The consultant should also be familiar with banking operations and workout situations for troubled firms. Previous experience in privatization is highly desirable. Previous working experience in Slovakia and some knowledge of Slovak are also highly desirable.

Reporting Relationships. The consultant(s) will work directly with the Ministry of Economy, and will interact with related ministries and agencies as discussed above, as well as the World Bank.

Source of Funding. According to an agreement between USAID and the Slovak Ministry of Economy, USAID is to provide, through the Deloitte & Touche IQC, a total of 200 days of ad hoc economic and financial advice to the Ministry of Economy under USAID Delivery Order No. 15. Approximately 90 days of this time remain uncommitted. The source of funding for this assistance is therefore this remaining available time under Delivery Order No. 15.

Timetable. Given the importance of this issue to the Slovak economy, it is desirable that this commence as quickly as possible. Mid to late March 1993 is a desirable time for the work to commence.

Dr. Igor Kosir
Director
Center for Strategic Studies
Kycerskeho 1
812 70 Bratislava

May 5, 1993

Dear Dr. Kosir:

I am please to enclose for your consideration, as we have discussed, and as USAID has suggested, a copy of a paper I previously wrote on models of economic growth and military expenditures.

I understand that your center is or will shortly be developing macroeconomic models to further your analysis of a number of topics. You may find the references in the paper to the RMSM, or Revised Minimum Standard Model, to be of interest. This is generally the modelling tool employed by the World Bank and USAID for macroeconomic projections. While the model has limitations, it has proven its usefulness as a programming and analytical tool.

Second, you may also find the discussion of modelling for military expenditures of interest, particularly in the present circumstance in Slovakia where the armaments sector is undergoing substantial conversion.

I would naturally be please to discuss any of these points further with you at your convenience.

Sincerely,

Michael P. McLindon
Advisor, Ministry of Economy

Military Expenditures in Models of Economic Growth

Prepared by

Michael P. McLindon

Ministry of Economy

April 1993

Military Expenditures in Models of Economic Growth

This paper relates the five potential effects, suggested by the literature, of military expenditures to theories of economic growth. These five principal conduits are:

(1) The Resource Mobilization Effect--Military expenditures (milex) reduce saving because:

--government spending on milex means less for social services, more expenditure by households on these services, and correspondingly less saving

--additional taxes may reduce personal saving

--the atmosphere created by milex may increase the social discount rate and thus favor more consumption over saving.

--on the other hand, military expenditures--especially if financed by money creation--could create inflation, which, some argue, could lead to a greater level of saving.

(2) The Resource Allocation Effect--military expenditures divert resources from domestic investment, lower the level of investment and thereby reduce the rate of economic growth. It may also displace productive government spending, such as expenditures on improvements in the agricultural sector or infrastructure, which would promote growth in later periods. Military expenditures may similarly affect the productivity of investment. The expected impact on growth is negative.

(3) The Foreign Resource Effect--military expenditures may be import intensive, and thus lower the level of foreign exchange that would otherwise be available to the economy.

(4) The Spin-off Effect--military expenditures have positive impacts on economic growth through spin-off effects on technology, human capital, civic action and the production of certain goods and services.

(5) The Aggregate Demand Effect--in an economy with excess production capacity, increased aggregate demand from military expenditures will increase output, increasing capacity utilization, which increases profit rates. Higher profits may increase investment, and put the economy on a faster long-term growth path.

The consensus from the literature suggests that on average the impact of the first three effects outweighs the latter two, and therefore the overall impact of military expenditures on growth is negative.

However, the empirical studies from which these propositions are extracted have the usual problems of data availability and reliability, and model specification, which has produced inconclusive or conflicting results. Thus, these five effects are best viewed as hypothesis to be tested in any particular country.

It is important to note, as several authors surveyed in the literature have stressed, that the theories of economic growth do not a priori indicate whether military expenditures will promote or hinder economic growth. Rather, they specify the key variables that affect growth. Research on the issue has focused on trying to identify the nature of the impact of military expenditures on the different variables that can affect economic growth. As the above indicated, there can be simultaneously positive and negative effects, flowing through different channels.

Modern Growth Theory.

Modern growth theories can be divided into two basic models: post-Keynesian and neo-classical models. The post-Keynesian models emphasize the sources of aggregate demand such as consumption, investment, government purchases and net exports. The neoclassical models focus on the factors that affect aggregate supply, such as the labor force, capital, and level of technology.

Because the classical and Keynesian models are important in the development and discussion of the growth models, their essential features are first summarized.

The Classical World. The classical economists--those from Adam Smith to the time of Keynes--emphasized the importance of supply in economic performance and growth. Their relative disinterest in demand stemmed from Say's Law, which maintained that general overproduction of goods relative to total demand is not possible since supply (production) creates its own demand. Say's Law was based on the view that people work to obtain the income required to purchase desired goods and services. The purchasing power necessary to buy (demand) desired products is generated by production.

In classical theory, output could temporarily exceed demand in the short run, but wages and prices would be adjusted accordingly until the surplus was eliminated and the economy was directed to full employment. The rate of growth of per capita output is determined by the accumulation of capital relative to the growth of labor and on the pace of technical progress.

The Keynesian System. The breadth and depth of the Great Depression posed a serious challenge to the classical world view, which the basic Keynesian model rejected. Keynes argued that spending induced business firms to supply goods. If total spending fell, business firms would respond by cutting back production. Less spending would thus lead to less output. Keynes also argued that wages and prices are highly inflexible, particularly in a downward direction, in modern economies characterized by large business firms and powerful trade unions. Wage and price reductions are thus ruled out as a feasible mechanism for directing the economy to full employment.

In the Keynesian view, changes in output, rather than changes in prices, direct the economy to an equilibrium. A Keynesian policy prescription is that if the private components of demand--consumption and investment--are not sufficient to ensure the full-employment level of output, then the government should spend enough to push the economy to the full-employment level. It does this through the working of the multiplier, discussed below.

In a simple Keynesian model, planned expenditures on consumption, investment, government and net exports sum to planned aggregate expenditures. In turn, producers supply only the quantity of goods they believe consumers, investors, governments, and foreigners (net exports) plan to purchase at existing prices. Equilibrium is present in the Keynesian model when planned aggregate expenditures equal the value of current output. If an economy is in Keynesian equilibrium, there will be no tendency for output to change even if output is well below full employment capacity.

Aggregate expenditures are the sum of spending by the four sectors-consumption (C), investment (I), government purchases (G), and net foreign expenditures (X).

$$AE = C + I + G + (X-M)$$

At equilibrium national income, or Y, = AE

Keynes believed that current income is the primary determinant of consumption expenditure, with saving as a residual. (In the classical system, saving depends on the interest rate, with consumption as a residual.) Specifically, as people's incomes rise, they will consume more, but their consumption will not rise by as much as their income increases. The fraction of their additional disposable income that they consume is know as the marginal propensity to consume.

$$MPC = \frac{\hat{}C}{\hat{}Y} = c$$

Since the marginal propensity to consume (c) plus the marginal propensity to save (s) equal one, the multiplier may be written as:

$$\frac{1}{s}$$

Investment expenditures are viewed as independent of income, and primarily a function of current sales relative to plant capacity, expected future sales, and the interest rate. Government expenditures are viewed as a policy variable.

Exports are dependent on spending choices and income levels abroad, and unaffected by changes in a nation's domestic income level. Therefore, exports remain constant when income changes. In contrast, increases in domestic income will induce consumers to purchase more foreign as well as domestic goods. Therefore, the level of imports increases as income rise.

The condition for equilibrium is that actual output equals aggregate demand:

$$Y = C + I + G + (X-M)$$

Changes in income are equal to the sum of changes in sector expenditures:

$$\hat{}Y = \hat{}C + \hat{}I + \hat{}G + \hat{}(X-M)$$

If we assume for simplicity that there is no change in investment and net exports, then the change in income is equal to:

$$\hat{}Y = \hat{}C + \hat{}G.$$

From above:

$$\hat{}C = c\hat{}Y$$

$$(1-c)\hat{}Y = \hat{}G$$

$$\frac{\hat{}Y}{\hat{}G} = \frac{1}{1-c}$$

This last equation defines the "government multiplier," which for the purposes of this analysis would be the impact of additional, autonomous government spending on, e.g. military expenditures.

Post Keynesian Growth Models. Keynes stressed that full employment is not automatically achieved. With this orientation toward the short-run employment problem, Keynesian economics tended to ignore long-run growth and the role of capital accumulation in growth.

Harrod and Domar first bridged the gap between the Keynesian theory of employment and the dynamics of long-run growth. A central part of the Harrod-Domar model is that investment has a dual character. On the one hand, investment contributes to aggregate demand and thereby helps to promote full employment and full capacity in the short run. On the other hand, investment involves expansion of the stock of capital and therefore contributes to the supply of output that the economy is capable of producing.

A key point in the Harrod-Domar model is the rate at which investment must grow in order for full capacity output to be maintained. To do this, Harrod-Domar adds to the Keynesian model of income determination the assumption that output is proportional to the size of the capital stock.

The equilibrium growth rate is derived from three underlying equations:

$$S = I$$

$$S = sY$$

$$^\wedge Y = (1/@)*I,$$

where

$^\wedge Y$ is the change in real income

I is net real investment, i.e. the change in the stock of capital

S is real saving

s is the marginal propensity to save

$@$ is the incremental capital-output ratio.

By combining the above equations, we can arrive at the equilibrium rate of growth:

$$^\wedge Y = (1/@)*sY$$

or $^\wedge Y/Y = s/@ = g$, the equilibrium growth rate.

If one introduces a government sector and exports in this model, this growth equation becomes

$$g = \frac{s-b-c}{@}$$

where

b is governmental expenditure as a proportion of national income

c is imports minus exports as a proportion of national income

Thus, in this model the growth rate will be determined by the savings ratio, the government budget ratio, the current account ratio and the incremental capital output ratio.

Two-Gap Growth Models. Two-gap models have been developed in the Harrod-Domar framework--i.e., they rely on a specified saving rate and a given capital-output ratio to determine feasible levels of growth in developing countries.

In two-gap models, two independent resource constraints inhibit growth. First, the required level of investment to realize the growth potential of an economy is not available because the economy cannot generate the needed savings. Second, domestic growth is constrained by access to foreign exchange, or the inability to run current account surpluses. Since foreign inflows can both add to domestic saving and provide the foreign exchange for imported inputs for which there are no close domestic substitutes, the latter constraint is generally considered to be dominant.

Economists at AID and the World Bank frequently use the two-gap approach for macroeconomic projections and policy work. The Revised Minimum Standard Model (RMSM) is a type of two-gap model that is widely used.

The RMSM itself is essentially an accounting framework that links the national accounts and the balance of payments, and pays particular attention to the foreign financing gap and projections of foreign borrowing. Some important features of the model are:

--An incremental capital-output ratio (ICOR) is either historically or technologically given. This permits one to obtain either the growth of real GDP based on the available level of investment, or, more typically, the required level of investment consistent with a desired rate of growth.

--The private sector saving function is stable and historically given.

--There is a stable relationship between imports and GDP.

--Exports are determined exogenously.

Thus, the RMSM relies on the assumed behavioral relationships for saving, investment, and output. Typically, a targeted growth rate for the following year can be set based upon consensus estimates of attainable growth. Meeting this growth rate entails a minimum level of investment in the present year, which through the incremental-capital output ratio (ICOR) determines the level of output next year. The financing of investment comes from domestic saving, which is determined by output, which may not equal the required investment. Thus, there may be a gap ex-ante between saving and investment.

The other critical sector is foreign trade. Several categories of imports are usually specified. As noted above, the model assumes a stable relationship between imports and GDP. For example, the level of growth of petroleum imports and GDP is given by the historical relationships of GDP and petroleum imports. Capital goods are linked to the level of required investment. As noted, exports are determined exogenously.

In order to meet targeted growth rates, imports usually have to rise relative to the fixed level of exports, creating a second gap ex-ante. By including factor and non-factor services, the current account deficit corresponding to different growth targets can then be calculated. The donors then try to identify sources of funding--including balance of payments and project financing--to close the gap between exports and imports. In the models, the gap between exports and imports is usually larger than that between investment and saving. In this case, closing the export-import gap also closes the investment-saving gap.

Although the model obviously has limitations, it has proven its usefulness as a programming and analytical tool. As discussed below, several of the key macroeconomic variables upon which military expenditures are hypothesized to have an impact can be modelled in this framework.

Neoclassical Models. In analyzing developed economies, the Harrod-Domar model has been superseded by neoclassical growth economics. Part of the differences in the two models lies in the purpose to which they were used: while Harrod-Domar calculated the rate of growth that was necessary to maintain full employment, neoclassical theory takes full employment for granted and attempts to analyze the long-run growth path.

In Harrod-Domar model, potential output is proportional to the stock of capital, and capital is the only factor of production. Neoclassical theory more realistically allows for the possibility of substitution between labor and capital. It also incorporates diminishing returns to the factors of production, technical change and other economic processes such as the depreciation of the capital stock.

Neoclassical growth theory assumes that output is at the full employment level, and that the supply of labor, independently of real wages, grows at a constant exponential rate.

Neoclassical theory employs an aggregate production function for the economy that allows for factor substitution and technical change, the most familiar of which is the Cobb-Douglas function:

$$Y = Y(L,K,A)$$

in which L is labor force, K is capital and A is the parameter for the state of technology.

In the model, investments are defined by the increase in the capital stock:

$$I = dk/dt$$

Savings are proportional to national product

$S = sY$

The equilibrium condition is

$I = S$

Therefore

$dk/dt = sY$

and

$gk = (dk/dt)/K = sY/K$

A necessary condition for balanced growth is that the growth rate of capital is constant. This can be realized only if the growth rate of production equals that of capital.

One well known but curious characteristic of equilibrium growth in the neo-classical model is that the growth rate is not a function of the saving rate. This differs from the Harrod-Domar result that the growth rate is the quotient of the saving rate and the ICOR.

The reason for this difference is that an increase in the fraction of income saved will accelerate the growth of capital and output temporarily, but diminishing returns will eventually restore the original growth rate. An increase in the fraction of income saved cannot therefore permanently raise the growth rate.

However, although the equilibrium growth rate is not a function of the saving rate, the saving rate determines the capital output ratio. Thus, the fraction of income saved affects the level at which he economy grows (the initial conditions) but it does not affect the rate at which it grows.

Military Expenditures in Models of Economic Growth

The following section relates the variables that the literature has identified as having an impact--positive or negative--on economic growth, and relates them to the post-Keynesian (Harrod-Domar and two-gap) models and the neo-classical model.

Resource Mobilization Effect. In the post-Keynesian models, a lower savings ratio results in a lower growth rate. Thus, if the Resource Mobilization effect is present in a particular economy, the growth rate would be lower. In a neo-classical model, by contrast, the rate of growth would not be affected. However, it would lower the level of the growth path.

Resource Allocation Effect. If this effect is present, it would tend to lower growth in both types of growth models. In a two-gap model, if investment in the present year is crowded out, it will lower the level of output and growth rate observed for the following year. If absorptive capacity constraints are present because government economic expenditures are squeezed, there will be less private investment and the growth rate will be lower. If the agricultural sector lags behind the industrial sector because military expenditures squeeze investment in agriculture, the agricultural sector's ICOR will be higher (more investment needed to obtain a given unit of output), and the growth rate will be lower. If investment is less productive because of absorptive capacity constraints related to squeezed economic expenditures, the ICOR will also be higher, and the growth rate will be lower.

In the neo-classical model, the growth rate is a function of the growth of the capital stock. Any of the above sub-conduits of the resource allocation effect would reduce the growth of the capital stock and thus lower the growth rate.

Foreign Resource Effect. A two-gap model such as the RMSM shows that any diversion of foreign exchange resources from military expenditures would ceteris paribus reduce the attainable growth rate. This effect on growth could also be delineated in a neo-classical model if the growth of the capital stock were impaired because needed capital goods were not available and/or because foreign technology was displaced by military expenditures.

The Spin-Off Effect. If there are positive "spin-offs" from military expenditures, these would tend to result in a lower ICOR (less investment is needed per unit of output) in a post-Keynesian model and thus an increased rate of growth. In a neo-classical model, spin-offs would increase the level of technology and result in a higher growth rate.

Aggregate-Demand Effect. This effect is clearly Keynesian in nature, and related to the multiplier outlined above. However, the multiplier is a static concept, while the proposers of the aggregate-demand effect suggest that this can have a dynamic effect on long term growth. This effect is not possible in a neo-classical model, since it assumes full employment of resources.

In general, tracing the hypothesized effects of military expenditures through the post-Keynesian and neo-classical models do not lead to radically different results. This is because both fundamentally stress, in different ways, the importance of capital formation and technology.

TABLE OF CONTENTS

ACRONYMS

BOT	Build, Operate and Transfer
BT	British Telecom
CSE	Colombo Stock Exchange
EGAT	Electricity Generating Authority of Thailand
GDP	Gross Domestic Product
GSL	Government of Sri Lanka
IFC	International Finance Corporation
IMF	International Monetary Fund
KEPCO	Korean Electric Power Corporation
SOE	State Owned Enterprise
TOT	Telephone Organization of Thailand
ZPA	Zambian Privatization Agency

All $ figures are for US$ unless otherwise indicated.

1

INTRODUCTION

Impressive results have been achieved in securities markets in developing countries. The International Finance Corporation (IFC,1991) reports that during the 1980s, the leading emerging stock markets grew dramatically in terms of market capitalization, value traded, the number of listed companies, and in the amounts of new capital that companies were able to raise from share sales in their domestic markets. General economic reform, the increasing interest of foreign portfolio investors, and privatization have played important roles in the growth of these securities markets.

Privatization has also shown remarkable progress. After years of analysis and debate in the 1980s, privatization has is becoming a major part of structural adjustment in a growing number of developing countries. More than 2,000 SOEs have been privatized in developing countries.

Governments in the leading countries of Latin America and Asia have sold billions of dollars worth of shares in state enterprises in the last few years. Argentina, Brazil, Mexico and Venezuela raised the equivalent of more than $15 billion through privatization in 1991. Governments, especially in Asia, have also been successful in arranging for private sector financing, management and ownership of infrastructure projects worth billions of dollars under build-operate-transfer (BOT) agreements.

The broad based share sale strategy is one that most helps securities markets development. Using the broad-based strategy, the government can use privatization to popularize stock market activities, increase the number of new investors, help channel new savers into ownership of industry and commerce, and develop the size and liquidity of secondary markets.

Many countries already have, or are considering, the broad-basing approach to privatization. It has been adopted as a strategy in Jamaica, Sri Lanka, Turkey, Tunisia, Nigeria, Chile, Mexico, Argentina, Venezuela, Malaysia, Zambia and other developing countries. The success in implementing this strategy has varied, as have the tactics employed. Disappointments most typically occur because of poor structuring of the privatization transaction, poor marketing and/or an unattractive price.

Privatization, especially by broad based share sale, can also have the following ancillary impacts on securities market development:

A demonstration effect for the private sector to float shares and list on the exchange, and for the financial community to develop corporate finance capabilities;

Enable institutional investors to become active securities markets agents;

Enable the stronger SOEs to come to market and add depth and stability to it;

Attract direct and portfolio foreign investment, which will make the securities markets stronger.

As for linking securities markets development with privatization, there will necessarily be a shift in emphasis. Most of the significant privatizations in developing countries have taken place in the more advanced emerging markets. While there are more than 100 lower and middle income countries, there are only 32 which have stock markets of significant size, i.e. large enough to warrant reporting on by the IFC.

In almost all cases, the stock markets and stock exchanges were created before the initiation of a privatization program. The challenge for the 1990s is for policy makers to more strategically exploit the synergies that exist between privatization and securities market development to further financial liberalization and economic restructuring in the "pre-emerging" developing markets and countries in Eastern Europe and the former Soviet Union.

Notions of the possible among policy makers continue to expand as the state of the art develops further. For example, it appears that Czechoslovakia's program of "mass privatization" (initiated before the recent division of the country) has succeeded in creating millions of shareholders and in privatizing hundreds of companies within a relatively short period of time.

Policy makers often wonder about the level of infrastructure required for securities markets, especially when large scale share sales are about to be undertaken. The paper argues that the required level is much less than commonly supposed. Regulatory considerations are less important when the government sells its shares since it structuring and pricing decisions will do far more than complex regulations to safeguard investors' basic interests. Market forces will help to ensure that exchange operations develop satisfactorily, especially if the exchange operates on a private sector footing.

The most important thing the government can do is to create an market oriented policy environment which helps to overcome obstacles to the supply of and demand for securities.

2

SECURITIES MARKETS AND PRIVATIZATION

Securities Markets.

Definitions. Financial markets include both capital markets and money markets. The money market is where short-term debt instruments with maturities of one year or less are traded. Capital markets deal in instruments of a year or more, and include long-term debt obligations and equity instruments. In general, money market instruments have low default risk and high marketability. Capital market instruments, on the other hand, involve relatively higher degrees of risk.

The role of capital markets is to facilitate the transfer of funds from savers to long-term borrowers who invest in the physical capital needed to produce growth and economic development. The role of capital markets in development has too often been reppressed by inadvertent but pernicious policy, a situation many governments are working to redress.

Capital markets may be divided into the primary market, where new equity and debt instruments are issued to finance new investment, and the secondary market, which provides a vehicle for buying and selling the instruments created in the primary market.

Capital markets can be further divided into securities and a non-securities segments. If suitable secondary markets exist, then securities can be traded relatively easily, which increases their attractiveness to investors. Examples of equity securities include common stock, preferred stock, and options and warrants; debt securities included bonds and convertibles. Non-securities on the equity side include private placements and venture capital, and, on the debt side, loans, mortgages and other asset backed loans.

This paper focus on securities markets since they have the greatest scope for development as a part of overall financial market liberalization, and are also the segment of capital markets most closely related to privatization. Because the market, especially the secondary market, for debt securities is largely non-existent in developing countries, this paper focuses further on the equity side of securities markets development.

Emerging Stock Markets. In the effort to develop capital and securities markets, policy makers are increasing assigning special importance to stock markets. This is because there is a tendency for debt to have too large a role in the economy, not only in the public sector (government borrowing), but also in the private sector (bank debt and overdrafts.) The correspondingly high debt-equity ratios increase the risk that companies may default on their debt.

Because the equity markets of many developing countries have the potential for superior long term capital appreciation, and have a fairly low correlation of return with the developed securities markets, foreign portfolio investors have shown a keen interest in what have come to be known, from their point of view, as "emerging markets."

The International Finance Corporation (IFC), the private sector arm of the World Bank which has taken a lead in promoting emerging stock markets, considers any market in a developing economy (as defined by the World Bank) to be an emerging market. The IFC follows emerging stock markets in 32 countries which are large enough to merit statistical attention. (Of these 32 countries, 20 countries are in its widely followed IFC composite index.)

As the IFC (1991) notes, the larger emerging markets demonstrated significant growth in size and sophistication. This has been an important part of the movement to free markets and accord a greater role for the private sector worldwide.

For the 20 IFC composite index countries, from 1981 through 1990:

- Total capitalization increased from $79.2 billion to $464.4 billion.

- As a percentage of GDP, capitalization increased from 6% to 32%

- The number of listed companies increased from 4,904 to 10,253.

- Value traded increased from $31.9 billion to $885.7 billion

- In 1990, more than 1,200 companies in the 20 largest emerging markets raised over $22 billion from share offering in their domestic markets. In 1989, $28 billion was raised.

The following table provides basic data on the 32 stock markets covered by the IFC.

TABLE I

Largest Emerging Markets by Market Capitalization:
(1991)

	Market Cap (US$ Mil.)	Per Capita Income (US$)	Status*	Pop. (Mil.)
Taiwan, China	124,864	7,510	UMI	20.4
Mexico	98,178	2,490	UMI	86.2
Korea	96,373	5,400	UMI	42.8
Malaysia	58,627	2,320	LMI	17.9
India (Bombay)	47,730	350	LI	849.5
Brazil	42,759	2,680	UMI	150.4
Thailand	35,815	1,420	LMI	55.8
Chile	27,984	1,940	LMI	13.2
Argentina	18,509	2,370	LMI	32.3
Turkey	15,703	1,630	LMI	56.1
Greece	13,118	5,990	UMI	10.1
Venezuela	11,214	2,560	UMI	19.7
Philippines	10,197	730	LMI	61.5
Portugal	9,613	4,900	UMI	10.4
Pakistan	7,326	380	LI	112.4
Indonesia	6,823	570	LI	178.2
Colombia	4,036	1,260	LMI	32.3
Jordan	2,512	1,240	LMI	3.2
Sri Lanka	1,998	470	LI	17.0
Egypt (Cairo)	1,835*	600	LI	52.1
Nigeria	1,882	290	LI	115.5
Morocco	1,528	950	LMI	25.1
Zimbabwe	1,394	640	LMI	9.8
Peru	1,135	1,160	LMI	21.7
Jamaica	1,034	1,500	LMI	2.4
Trinidad & Tobago	671	3,610	UMI	1.2
Kenya	638	370	LI	24.2
Cote d'Ivoire	567	750	LMI	11.9
Costa Rica	311	1,940	LMI	2.8
Bangladesh	269	210	LI	106.7
Uruguay	44	2,560	UMI	3.1
Kuwait	na	na	na	2.1

*1990.

LI= Lower Income Economy, LMI= Lower Middle Income Economy, UMI= Upper Middle Income Economy

Source: IFC, Emerging Stock Markets Factbook 1992
World Bank, World Development Report 1992

The World Bank divides the developing economies into three categories, namely low income economies, low middle income economies and upper middle income economies. These countries total 100 in all. (They do not include, as of the 1992 World Development Report, the countries of the Former Soviet Union, nor some of the recently independent Eastern European countries.)

TABLE II

Developing Economies and Emerging Markets

	A. Developing Economies*	B. Emerging Markets**	C. Percent (B/A)
Low Income Economies:	42	9	21.4%
Low Middle Income Economies:	41	15	36.6%
Upper Middle Income Economies:	17	8	47.0%
Totals	100	32	32.0%

* As per the World Bank
**As followed by the IFC

These figures indicate that about two-thirds of developing countries do not have stock markets of any significant size, and, by extension, very developed securities markets.

Privatization Methods.

Privatization's role in economic reform and restructuring is straightforward: it enables a government to shift its portfolio of interventions away from those areas that the private sector can undertake as well or better, and to free resources which can be used for other purposes, such as meeting the social agenda in education and health.

The experiences from a number of countries stress that privatization is not an end it itself, but a part of a more general process of liberalization and reform of the economy.

Privatization in its most general sense assumes several basic forms:

- Closure. One privatization measure is to simply liquidate some state owned enterprises. This could be warranted if there were no combination of new investment, ownership and management changes which would give the enterprise a positive net present value.

- Deregulation. The government removes regulations which had previously prevented the private sector from competing with a nationalized monopoly, or creates new regulations to foster greater competition from the private sector.

- Contracting Out. A number of services, including management, can be contracted out to the private sector. This usually leads to a marked improvement in day to day operations. However, this is usually not sufficient to deal with the problem of needed new investment in plant, equipment and technology to keep the enterprise competitive.

- Leasing. Leasing is a more powerful tool than contracting out, since the returns to the lessee are more directly determined by the performance of the assets in question. Like contracting out, however, the problem of making new investment in the enterprise remains.

- Trade Sales. These involve the sale through competitive bidding techniques (or sometimes negotiated sales) of enterprises to the private sector. These usually involve some of the smaller enterprises.

- Management-Employee Buyouts. Occasionally, management and/or employees may be an ideal buyer for a state owned enterprise, especially for smaller enterprises. This is especially so when management is otherwise effective but performance has been compromised by regulations and other operational constraints. Financing is usually required in order to complete the transactions, which can take the form of payments by installment.

- Public Share Sales. These are typically for the larger state owned enterprises. Properly structured, marketed and priced, this types of privatization can help to popularize the privatization program while giving a boost to the development of the capital market.

- Build-Operate-Transfer (BOT) infrastructure privatization. This type of privatization involves infrastructure (power, roads, bridges, ports, airports, solid waste, etc.) which the government would like to have constructed. It bids these projects out to the private sector, which assumes the responsibility for the financing, construction, and operation of the infrastructure project.

The latter two are generally the largest in terms of money involved, and demand the greatest financial sophistication. More so than the other forms, they benefit from, and contribute to, securities market development. Deregulation--that is, enabling the private sector to enter markets closed to it by government regulation or practice--is also be an important tool. With deregulation, the private sector has been allowed to offer banking, insurance, mutual fund and pension services, which are critical to developing securities markets, but too often moribund under government control.

Share sales have been the most salient form of privatization to date. The landmark privatization by the United Kingdom of British Telecom in 1984 made international headlines and has since provided a model for developed and developing countries.

The list of notable privatizations by share sales in developing countries continues to grow. The sale of 51 percent of the shares in the National Commercial Bank in Jamaica, which was oversubscribed and led to a tenfold increase in shareholders, has become a classic case study in transferring the privatization techniques of a broad based share sale from a developed economy (the United Kingdom) to a small emerging market country. In 1989 the Korean Government dramatically expanded the number of shareholders in Korea with the sale of $2.1 billion share of KEPCO, the power company. In 1990, the Government of Malaysia successfully floated 23% of the shares in Malaysia Telecom for $860 million. The Mexican Government's sale of $2.35 billion of shares of Telefonos de Mexico (Telmex) stock in 1991 is the largest international equity offering by a developing country.

At the same time, another form of privatization--BOT and its variants--is becoming more prominent in both developed and developing countries, and will have a growing impact on capital and securities markets.

Notable BOT projects in developing countries include the Malaysian North-South Expressway ($1.8 billion), the Bangkok Second Stage Expressway ($880 million) and the Shajiao Power Plant ($550 million) in the People's Republic of China.

Typically, a BOT project is sponsored by a contractor and equipment supplier who build and operate the required infrastructure for a predetermined number of years. BOT projects must be commercially viable so lenders can be repaid from project revenues, and investors can earn an acceptable rate of return. BOT projects tend involve large sums of money, are highly leveraged, and of long duration.

As a result, BOT projects draw heavily on capital and securities markets. At present BOT projects tend to rely more on the non-securitized side of capital markets, e.g., privately placed equity and bank loans. Some BOT project companies in developing countries (e.g. Thailand and Malaysia) though have sold debt and equity securities publicly.

3

IMPACT OF PRIVATIZATION STRATEGIES ON SECURITIES MARKETS

The key point about privatization is that the government is in control. As the owner of shares, it can structure the privatization to meet its broader objectives of economic restructuring and securities markets development. It is in a position to accept a lower revenue yield, or incur greater expenses, from the sale of its assets if by doing so it can help to build securities markets.

As the previous section indicated, share sales is the method of privatization that has the greatest impact on securities markets development. This is not surprising. However, the strategy employed for privatizing by share sale has a widely varying impact on securities markets development. It is important to note that the form of privatization employed that most helps securities markets to develop is generally also the best for the continuing progress of the privatization program.

Among the larger emerging market economies there have been several notable successes, but for many, privatization remains in the initial stages. They will need to aggressively link liberalization and reform with privatization if they are to develop the securities markets required to meet their needs for development of industry, commerce and economic infrastructure.

As noted above, the majority of developing economies do not have a stock market of any appreciable size. The issue of using privatization to develop securities markets is of particular significance for these "pre-emerging" market economies. These include countries as diverse as the Dominican Republic, Mongolia, and Zambia. Their efforts to develop securities markets will depend heavily on privatization.

The countries in Eastern Europe and the former Soviet Union are also "pre-emerging". Due to their recent history, and the overwhelming dominance of the state in the economy, they face development challenges of a somewhat different nature than the emerging or other pre-emerging markets.

<u>The Broad-Based Share Strategy</u>. The experience of Jamaica suggests that the "broad-based share sale" model of privatization, which was pioneered in the United Kingdom, can help countries structure privatizations to further securities market development. The

broad-based approach attempts to privatize SOE's by selling shares to as many new investors as possible. This is done through a well organized marketing and advertising campaign for the share sale, the creation of new distribution channels, and an attractive share price. As people become used to share ownership, either directly or through their mutual funds and pension funds, securities markets are developed and strengthened, they become stronger agents for further privatizations.

Using the broad-based strategy, the government can use privatization to popularize stock market activities, increase the number of new investors, help channel new savers into direct ownership of industry and commerce, and develop the size and liquidity of secondary markets.

Developing countries that are in the process of privatizing and developing securities markets are likely to be also undertaking a range of other structural adjustment and stabilization measures in order to grow faster. While many of the measures undertaken will cause some dislocation and hardship, privatization, if structured properly, will generally be one of the easier options in that it results in increased revenue for the state.

It is prudent for the government to demonstrate that the benefits of the adjustment program leading to growth will be widely spread. Thus, one of the main features of most privatization programs is the effort to spread ownership as widely as possible. This is critical to enlisting support for the overall program.

Many countries already have, or are eager to implement, the broad-basing approach to privatization. It has been adopted as a strategy in Jamaica, Sri Lanka, Turkey, Tunisia, Nigeria, Chile, Mexico, Argentina, Venezuela, Malaysia, Zambia and other developing countries. The success in implementing this strategy has varied, as have the tactics employed. Disappointments most typically occur because of poor structuring of the privatization transaction, poor marketing and/or an unattractive price.

The number of shareholders as a percent of the population is minuscule in most emerging market countries. In developed countries, individual shareholders as a percent of the population typically range from about 10 to 25 percent. By contrast, before privatization, there were only about 50,000 individual shareholder or 0.2 % of the population in Argentina, 400,000 or less than 1% in Thailand, 25,000 or less than 0.2% in Sri Lanka, and 3,000 or about 0.1 % of the population in Jamaica. Jamaica was able to attract 30,000 new shareholders as a result of privatization, and Sri Lanka an additional 25,000 shareholders. Further, Chile and Nigeria were able to attract 63,000 and 400,000 shareholders respectively as a result of privatization share sales. (The number of shareholders in Chile has subsequently increased with the privatization of its telephone company.)

The benefits of the broad-based approach may be summarized as follows:

- It can promote share distribution in SOEs to a broad and diversified segment of the population.
- It can create a new class of investors who will also be able to support additional share offers of SOEs as well as private sector companies.
- It may be the only practical way to privatize a group of large state-owned enterprises over time, especially if local institutional investors are underdeveloped.
- The local securities industry will benefit if the base of shareholders is expanded.
- It can mobilize previously untapped savings.
- It can help to recapture capital flight.

In the broad-based share sale model, when the government is trying to develop the securities markets, it is usually advisable to structure the share sale so that the price per share is low and attractive relative to value. That will make the shares more appealing to investors, especially those buying shares for the first time. It will help to achieve an oversubscription, and a successful transaction. It also creates a healthy aftermarket.

The government may have to forego some of the revenue indicated by a valuation report. However, part of that can be to some extent recovered in later privatization transactions once the program is launched with a successful first transaction.

To be sure, the broad-based approach cannot be applied indiscriminately. The decision to broad-base depends in part on the size of state-owned enterprise. Broad-basing requires more time and money than a traditional share sale. Attracting a large numbers of applicants is a costly process. Below a certain minimum size for a state owned enterprise, it is not cost effective, and trade sales by competitive bidding may be best. It is also unlikely that a small state-owned enterprise would have the desired demonstration effect.

Still, there may be pressure to simply "get the deal done" and disregard a broad-basing approach for an otherwise suitable candidate. If the shares can be easily sold by private placement to a relatively small number of traditional local investors (and perhaps a large foreign investor), then the underwriters, selling agents and the state owned enterprise will usually prefer this approach, since it easier to do.

The government, on the other hand, has the ability--and indeed, the obligation--to look beyond the short term gain of a particular transaction, and consider the longer run interests of the financial sector and the fledgling securities market.

Obviously, it is unwise to compromise the integrity of the privatization transaction to pursue secondary objectives. However, in the majority of the cases, paying attention to taking advantage of the securities market implications of a transaction will make for a stronger privatization program.

Another potential problem with the broad based approach is that, if taken to the extreme, it can result in a large number of shareholders who do not have a large enough position to exercise the true powers of ownership on management. Several countries have tried to mix both a group of core investors which can direct management, with a larger number of smaller shareholders who can benefit from the enterprise's growth over time.

Sri Lanka's privatization strategy, known as the "60-30-10" approach, has enabled it to achieve both broad-based share holding with related objectives of finding core investors, obtaining increased foreign investment, and ensuring employee participation. In chronological order, 60% (i.e. majority shareholding) of the corporatized state owned enterprise's shares are sold by a public tender process to an investor (usually foreign) who can bring the resources to make the enterprise more competitive. Thirty percent is then offered to the public in a public share offer, and 10% is given to the company employees. (The actual percentages can vary somewhat depending on the enterprise).

The strategy has several notable features that merit consideration by other countries. Selling 60% to a foreign investor helps provide new management, technology, access to markets and financing, and the majority shareholding ensures that the investor will have sufficient interest to make the company work. Selling 30% to the public helps to supply much needed shares on the market, which has been a key constraint facing the development of Sri Lanka's stock market.

A 30% local holding also serves as a check on the foreign investor by requiring that the company issue annual reports and hold public stockholder meetings. Finally, 10% of the shares are given to the employees This helps to turn what is normally a group opposed to privatization into a supporter.

As Sri Lanka's program advanced, the Government of Sri Lanka has developed an alternative "fast track" privatization approach. It can simply list companies in which it has majority ownership on the stock exchange. It then offers to sell a block of at least 51% of the shares through a sharebroker to competing corporate investors. The winner is simply the highest bidder on the exchange for the block of shares. It is relatively simple and very transparent. The remainder of shares are disposed of in smaller blocks of shares through the secondary market, to the general public, and by transfer to the employees.

The impact is essentially the same as the "60-30-10" strategy in terms of creating core investors, attracting new resources, and later broad-basing a minority portion of shares in the company and including employee participation. It avoids some of the lengthy procedural difficulties (marketing, tendering, evaluation, and transparency) that had been encountered in selling the majority shareholding block with the "60-30-10" approach.

Some Sri Lankan officials, however, have expressed some reservations about this process because they feel it does not allow them to clearly establish the intentions or bona fides of the majority shareholding. Others argue that the money an investor is actually willing to spend to acquire the enterprises is the best possible expression of intentions and bona fides.

Strategies for Pre-emerging Markets. A key question, then, is how far privatization can proceed in the absence of a formal securities market. A fair conclusion seems to be that the operational and regulatory environment needed for a stock market to function are less than is commonly supposed. A securities market with imperfections is to be preferred to no securities market at all.

The experience of Jamaica answered in part the question of whether countries without large, sophisticated securities markets could undertake large scale privatizations. The Jamaican stock market only had about forty listed companies, with thin and erratic trading volume, and was open for trading only twice a week for two hours per session at the time of the share sale of the National Commercial Bank in 1986. There had been only two minor share sales in the preceding decade. There was no independent body regulating the stock exchange, and there were no specific laws against insider trading. At the time of the privatization by broad based share offer, the market capitalization of the Jamaican Stock Exchange was only about $500 million.

As it turned out, the share offer was oversubscribed and led to a ten-fold increase in the number of shareholders. The subsequent share offers of the Caribbean Cement in 1987 and Telecommunications of Jamaica in 1988 showed beyond a doubt that the U.K. broad based model could work in a much smaller market, and dispelled the notion that underdeveloped securities markets in themselves are an impediment to privatization.

However, within the class of emerging markets, Jamaica's financial system was in fact fairly sophisticated. Its accounting and auditing standards are relatively high, and investors typically have a high degree of confidence in the reported financial statements of enterprises. It also has an adequate companies law. Its base of private sector institutional investors was relatively large and sophisticated. Jamaica was therefore not typical of the majority of developing countries whose securities markets are "pre-emerging."

The question for the "pre-emerging" market countries is the extent to which privatization by share sale can take place in the absence of formal securities markets.

A basic proposition of this section is that the range for privatization transactions through share sale is much larger than usually believed. Further, a stock exchange is not necessary for even a large-scale share sale, provided that there is some means for the investors to sell their shares. The process can begin with a well established institution serving as the forum for trading on an over the counter basis.

To policy makers, a formal stock exchange is a concrete example of financial and economic progress, and often pursued as an end in itself. In some cases this focus can unfortunately obscure the need to make more fundamental but difficult policy changes which would do much more to help the securities markets develop than a new stock exchange building. In addition, a stock market and exchange have to be developed gradually.

Even without a significant private financial institution, it is possible to arrange for a small public offering of a well known, popular and profitable enterprise. The market demand will come predominately from individuals, assuming that marketing and publicity have been effectively undertaken. The supply of shares should be several times smaller than estimated demand to ensure an oversubscription. The shares will need to be attractively priced.

In the Dominican Republic, historical circumstance has played a role in the ownership of assets by the government. After 31 years of dictatorship, Trujillo had accumulated substantial assets. In 1962, following Trujillo's death, the state became the owner of those assets. Today, the Dominican Republic has no privatization policy per se, although the government has undertaken some limited, ad hoc privatization measures, largely involving management contracts. It approach to the more substantive forms of privatization is one of curiosity tempered with circumspection.

The Corporacion Dominicana de Empresas Esatales (CORDE) was formed in 1966 as a holding company for the government's majority holdings of 24 enterprises. CORDE also has minority shareholdings in 15 other enterprises.

The government could launch it; program without creating too much controversy, and with reasonable prospects for success, by having CORDE sell its minority ownership of 15 enterprises. Options for doing this would include a private placement of shares. A bolder and more helpful measure, which could help to generate more popular support for privatization, would be public share offers and listing on the stock exchange (which basically trades short term debt instruments), which was established in 1992.

Zambia is an example of a country facing many adversities, which is nonetheless trying to develop a privatization program, including a broad-based approach. It also has a small stock market which it is trying to develop in step with its privatization program, and would like to set up a stock exchange.

The Zambian economy, which is heavily dependent on copper, suffers from severe distortions, including a large, inefficient SOE sector. The Zambia Industrial and Mining Corporation (ZIMCO), is the state holding company for some 120 parastatals.

The Government plans to divest most of the ZIMCO parastatals. The objectives of its privatization program include encouraging the wide ownership of shares and promoting the growth of securities markets.

The government plans to sell a first group of small SOEs by competitive trade sales. In 1993, it plans to launch the privatization of larger SOEs by public share offer.

A stock market already exists in Zambia. Several thousand Zambians already own and trade shares in such companies as the Standard Chartered Bank and Bata Shoes, and local mutual funds which invest in equities, government bonds and real estate. These securities were traded through an informal over the counter market in the financial sector.

The Zambian Government enacted a Stock Exchange Act in 1990 to provide for the legal framework for the establishment of a stock exchange in Zambia. One ironic, unfortunate effect of this act was to suspend the over the counter market, since the act required all brokers and dealers to be licensed by the Stock Exchange Council, a regulatory body stipulated by the act but not operational many months after its passage.

With the over the counter market temporarily out of operation people had to resort to placing adds in the newspaper to sell shares. Not surprisingly, spreads between buying and selling prices were high, pointing to the inefficiency of this unusual trading mechanism! Fortunately, under the Privatization Law of 1992, banks and financial institutions were given authority to trade in shares, and the over-the-counter market is back in operation.

In fact, there is general consensus in the financial sector that the less formal, over-the-counter market among Zambia's existing financial institutions could adequately serve trading needs following a privatization by share sales which Zambia's privatization program currently envisions.

Ideally, the stock exchange could evolve naturally out of a less structured over-the-counter market as the demand for and supply of shares increases from privatization and other private sector companies deciding to list.

Structuring privatization transactions will be one of the key tasks of government's technical unit, the Zambian Privatization Agency (ZPA.) Given the present state of the Zambian economy, the low level of disposable income among Zambians, the rudimentary state of its financial markets, and the general lack of experience of the Zambian public with share ownership, the first attempt at a share offer should be modest. The SOE selected for share offer should be well known and in good financial, managerial and competitive shape. Only a small percentage of the shares should be sold in an effort to gauge the breath and depth of the market. The shares should be very attractively priced to encourage demand. While advertising and marketing should be broad based, only a few hundred or perhaps thousand shareholders should be expected to subscribe.

Such an approach may be less far-reaching in its efforts to encourage Zambian participation than policy makers may wish, but it is critical that the first share offer be successfully transacted. The best outcome would be that many more people subscribe than officially anticipated, and the offer be several times oversubscribed. If there is, as a result, a significant rise in share price in the aftermarket, then more Zambians will wish to participate in succeeding share offers, and the government can be slightly more ambitious in its objectives.

If, on the other, the first share offer is undersubscribed and the share price falls in after market, it will be exceedingly difficult to attract the Zambian public to succeeding share offers.

<u>Mass Privatization.</u> Given the overwhelming dominance of the SOEs in the economies of Eastern Europe and the former Soviet Union, these countries, privatization is urgently required.

Eastern Europe and Former Soviet Union are also trying to develop their securities markets while effecting large scale privatizations. In these countries, only a few months had passed before the liberated countries discussed the establishment of stock exchanges to help channel savings from individuals to purchase shares of the SOEs. Stock exchanges of one sort or another now exist in Bulgaria, the Czech Republic, Slovakia, Hungary, Poland and Russia.

Czechoslovakia (before its recent division into the Czech Republic and Slovakia) and Russia are perhaps taking the broad-based approach to its logical conclusion through their programs of "mass privatization." Vouchers are distributed to their citizens which they can use to buy shares in the thousands of companies that will be put on the block. Vouchers can also be sold to others.

Czechoslovakia began its program in June 1992. There are 8.5 million voucher holders (out of a population of 15.5 million) who paid a nominal fee for vouchers worth 1,000 investment points. These could be used to bid for stock priced in terms of shares per 100 investment points.

Initial information indicates that the program is working. In the first two auction rounds, almost all the 8.5 million vouchers holders bid for shares in almost 1,500 state companies, valued at $11.2 billion. Thus, the plan has already succeeded in its goal of creating millions of shareholders almost instantly. It has fully privatized 122 SOEs in two months, and sold shares in hundreds of others. (Economist, Sept. 12, 1992.)

The after market is now the main issue. The actual distribution of shares has yet to take place. Trading in shares apparently must await a new securities law. Alternately, the authorities may allow shares to begin trading without any laws. How the division of country on January 1, 1993, will affect the process is not clear at this point. These events represent the most interesting development in privatization and securities markets developments, and should be evaluated in detail for their "lessons learned" once trading begins.

Russia launched its mass privatization program in late August 1992. The program is no doubt risky, and, as with Czechoslovakia's, has been roundly criticized in some quarters. The Economist (August 29, 1992) argues cogently that the "alternative is worse. As long as most firms remain nominally in state hands, they sit like a dead weight on Russia's struggling economy."

As with the broad based privatizations initiated in the 1980s, the program of mass privatization will depend on the technical skill that is brought to bear on the program, and the political will to sustai.. the process once difficulties occur. Hopefully, the concept of mass privatization, like that of broad-basing and BOT privatization, will be vindicated by those countries which have adopted innovative approaches to privatization and economic reform, while having the political wherewithal to see them through to completion.

4

HOW PRIVATIZATION HELPS SECURITIES MARKETS TO DEVELOP.

The following are general points on the secondary impacts of privatization on securities market development, which apply primarily to developed and emerging market economies, but also have relevance for the "pre-emerging" market countries, as well as Eastern Europe and the former Soviet Union countries.

1. Privatizations by share sale can have a demonstration effect by encouraging private sector companies to go public, and for the local securities industry to develop corporate finance activities.

In emerging stock market countries, the supply of shares is often the binding constraint in stock market development.

The difficulties in getting companies to list in emerging markets are well known. There is a reluctance to widen the ownership of family owned and run companies for fear of loss of control. This has limited new company listings and the availability for sale of shares held by family members in existing listed companies.

As other countries have demonstrated, some of the reasons for the reluctance of private sector firms to go public begin to ease once prices on the stock market increase in the initial phases of the market's development.

Privatizations can have a demonstration effect for private sector companies that might otherwise be reluctant to come to market. Another constraint on going to market is that corporate finance and underwriting activities are underdeveloped in emerging market economies. Because so many companies are financed either by directed credit, or limited to retained earnings and short term working capital, the local expertise to take private companies to market have not had much opportunity to develop. Private sector companies also may be poorly informed about the process and possibilities.

In Argentina, for example, it has been reported that despite the remarkable advances by the government in economic liberalization and privatization, the interest from private companies in raising equity was quite limited. This was attributed to the fear on the part of Argentine businessmen in going public, and a lack of knowledge on the part of local investment banks on to structure a share sale.

Well managed privatization transactions can help to set new standards for financial institutions, and help to create a "demonstration effect." Some of the areas where privatization can help to effect a transfer of financial technology to the private sector include underwriting, development of new securities, publicity on share ownership and marketing of securities, development of suitable documentation and prospectuses, development of distribution networks, and the development of share registers.

Several developing countries have been able to arrange for underwriting of their privatization share sales. In general, it is advisable to have the share sales underwritten because the application list may have to be held open for a relatively long period to accommodate unsophisticated, small, first time investors. During this period, a number of problems could arise.

In some countries, it may be impossible to secure underwriters who will charge anything less than a prohibitive rate. This was the case in the first two privatizations by share sale in Jamaica. By the time of the third, however, it was possible to secure underwriting at a reasonable commission because of the exposure gained by financial institutions in observing the first two privatizations.

In addition to common shares, privatization can introduce new securities to the market. Warrants are long term options which give the investor the right but not the obligation to buy shares at a future date at a specified price. They can trade separately from the underlying common shares. This was a feature of the Caribbean Cement Company share offer in Jamaica in 1987.

Convertible bonds permit the conversion into common shares after a certain period. As a part of its partial privatization of banks in Mexico in 1987, the government offered, in addition to common shares, subordinated convertible debentures with a 5 year maturity for private individuals and businessmen.

The marketing effort that goes into a well run privatization share sale can redound to the benefit of the financial community which are often unfamiliar with the corporate finance maxim that "deals are sold, not bought."

As a part of the broad-basing effort, the privatization team will often have to create new distribution networks, which can later be utilized by the financial community. In Jamaica, successful offering of the National Commercial Bank required a broad distribution system. The network developed consisted of the local branches of the Jamaican post office plus the branches of eligible banks serving as the points of distribution and collection. This network resulted in a total of some 400 retail outlets for the share offer.

2. Privatization can help to develop local institutional investors, a key to financial market development.

In mature securities markets such as the United States and the United Kingdom, life insurance companies and pension funds are an excellent source of demand for securities, since they can match their long term liabilities with long term assets like shares and other securities. These institutional investors tend to dominate the secondary securities markets.

In developing countries, while finding new individual investors is important, the real key to long term securities market development lies in the development of local institutional investors, such as life insurance companies, pension funds and mutual funds.

Local institutional investors help to develop sophisticated demand for capital market instruments. Conservative by nature, they are a source of stability and prudent management for aftermarket trading. By contrast, individual investors in emerging (and developed) markets are frequently speculative. In working with brokers and dealers, institutional investors help to foment the development of fundamental research capabilities on the economy, the stock market and individual companies to provide the information needed for sound investment decisions and efficient markets.

Institutional investors are underdeveloped in emerging market countries. Because of a series of government policies, they usually do not fulfill their role of mobilizing savings and converting them into productive economic uses. (See Vittas 1992.)

Often, the traditional sources of institutional demand are owned and controlled by the government. Privatizing them may not only bring new securities to the market, but also free them to play a dynamic role in primary and secondary securities markets.

Deregulation is often an effective privatization tool at the beginning. Where monopoly state owned institutional investors exist, for example, the government can open up the sector to private sector competition. In Zambia, the insurance market used to be dominated by the Zambian State Insurance Company (ZSIC). The Government now permits private sector competitors into the market once dominated by ZSIC.

Mutual funds are an important means of channeling individual savings to the purchase of securities under professional management. Open ended mutual funds (or unit trusts) are particularly helpful, since the number of shares may expand automatically. Sri Lanka passed special legislation to create unit trusts, which would be managed by the private sector. Four such unit trusts have been created. The measures were taken in conjunction with Sri Lanka's efforts to develop its stock market.

Chile successfully privatized its social security system in 1981 when it introduced a government mandated and regulated, but privately managed system. More than 80% of Chile's labor force contribute to pension funds, which invest in the local securities markets. Chile's total pension pool is estimated at US$ 7 billion, or 25% of the country's GDP. (Salomon Brothers 1992). The pension funds have purchased shares in the privatized state-owned companies, which represents about 95% of their total equity holdings. (Vittas, 1992.) Argentina, Venezuela, and Mexico are considering the privatization of their pension plans, and studying the Chilean experience.

3. Usual candidate companies for privatization are just the ones needed to add depth, liquidity and stability to the stock market:

One noticeable feature of emerging markets is their volatility. One frequently used measure of volatility is the standard deviation of total return. Table 6 indicates that emerging are more volatile than developed markets.

TABLE III

Volatility of Selected Stock Markets

(Five years ending December 1991)

Market	Annualized Standard Deviation
United States	18.53
EAFE	21.69
IFC Composite	27.64
IFC Latin America	42.05
IFC Asia	35.26

Source: IFC

There are several reasons for the greater volatility in emerging markets. One reason lies in the fact that, in their efforts to control the commanding heights of the economy, many governments acquired some of the largest and most important enterprises. Many of these enterprises, in the financial, telecommunications, power, cement, steel and other sectors, are in stable markets with strong cash flow. Privatizing them through share sale and listing them on the exchange will add the depth and stability that a young, emerging market needs to attract investors and encourage companies to list.

Moreover, these enterprises need access to large amounts of capital in order to grow and develop. Privatization puts them in a position to tap sources of private sector finance, where availability of the finance is largely a matter of prospects for risk and return, rather than a bureaucratic process of budget allocation as it is in the SOE sector.

The large and generally profitable SOEs in Thailand such as the Electricity Generating Authority of Thailand (EGAT) and the Telephone Organization of Thailand (TOT), for example, are in key areas of infrastructure, but their provision of services is not keeping pace with Thailand's dynamic economic growth. The Ministry of Finance would like them to attract private sector finance rather than depend on the government's budget for its capital outlays. Further, the SOEs tend to have high debt-equity ratios and need to strengthen their balance sheet. It would be beneficial for all parties--the government, the SOEs, and Thailand's equity market, and Thai citizens--for the SOEs to tap Thailand stock market through new share issues which can provide needed private sector capital while diluting the governments shareholding position over time.

Commercial Banks. Privatization within the financial sector has received much attention in recent years. Commercial banks are one of the most commonly privatized SOEs. Factors favoring their privatization include the fact that they are fairly well known among the population, they are fairly large, and usually operate in a competitive environment (i.e. private sector banks exist.) They frequently require some restructuring prior to privatization to shore up their balance sheet, which is often burdened with non-performing loans.

In Korea, the commercial banks were nationalized by President Park in 1961, and for years basically functioned as a passive conduit for low interest deposits to government approved investments. As a part of the government's program of financial reform, it privatized (by private placement) its equity in commercial banks in 1981 and 1982 in an effort to invigorate commercial banking.

The privatization of Mexico's commercial banks has resulted in some of the largest privatization transactions in the world. The Mexican banks were nationalized in 1982 by then President Lopez Portillo. Mexico has successfully privatized its 18 commercial banks over the last two years, realizing $12 billion in proceeds. Previously, when the banks were nationalized, retail and middle market loans were restricted. Since privatization, access to credit has been liberalized and a mortgage market created.

As noted above, Jamaica initiated its privatization by share sale with the National Commercial Bank. Other countries which have privatized commercial banks include Bangladesh, Chile, Venezuela, the Philippines, Trinidad and Tobago, Kenya and Guinea. (See Zank, et. al., 1992, for case studies.)

On the other hand, Sri Lanka, which has been able to privatize 19 SOEs and realize proceeds of $180 million, has been unable to privatize or even restructure its two state owned commercial banks.

This is hindering its efforts at financial reform. These banks, the Bank of Ceylon and the People's Bank, own more than 60 percent of the commercial bank assets, but are technically insolvent when internationally accepted accounting standards are applied. These banks need to be privatized following restructuring.

Telecommunications. Many of the largest and best known privatizations have been of telephone companies. In developed economies, these include the United Kingdom's British Telecom and Japan's NTT. Over 100 governments are currently considering some form of privatization of their telephone companies.

In Latin America and Asia, privatization of the telephone companies has improved services for customers, increased the growth of direct exchange lines, and improved management. Investors have seen total returns on their share investments increase significantly. Privatization in the telecommunications sectors has increased the depth and trading activity in local stock markets.

The privatization of Telefonos de Mexico (Telmex) occurred in a two-phase process. First, a controlling interest of Telmex was sold to the consortium of local and foreign investors December 1990. The government subsequently sold all but 10% of the company through an international American Depository Receipt (ADR) in May 1991. The $2.35 billion equity issue was the largest equity offering ever made by a developing country. The quality of telecommunications service in Mexico has improved as the controlling shareholders have set specific benchmarks for service quality and development of the network, including line growth of 12% a year.

Although most privatizations have been through the sale of shares, the telecommunications sector also lends itself to privatization by the BOT approach. Thailand awarded a concession to a local Thai company working with British Telecom and other foreign advisors to install 2 million lines in Bangkok, and another 1 million lines outside of Bangkok. The BOT company will install and operate the lines. Revenue proceeds will be divided between the BOT company and the Government of Thailand. The BOT approach is also being reviewed, inter alia, by Sri Lanka, Pakistan, and Bangladesh.

Power. Privatization by share sale in the power sector has not reached the same level as telecommunications, although there are examples in the United Kingdom, in Korea (discussed below), and in Malaysia. In developing countries, BOT seems to be the preferred method of privatization. Under this approach, a private sector group builds a power plant and sell electricity to the national grid under a power purchase agreement.

BOT projects are currently up and running in the People's Republic of China and the Philippines. In Pakistan, the US$ 1.2 billion Hab River oil fired power plant, a BOT operation, has finally broken ground, following many years of delay. Many other countries are looking seriously looking at BOT possibilities, including India and Sri Lanka.

It is almost inevitable that private sector finance, including securities instruments, will become increasingly involved in the power sector. Demand for power grows faster than the economy at the current stage of development of many developing economies. The governments (and the donors) are finding it impossible to lend enough to keep up with demand. The choice facing most governments, therefore is either to stifle economic growth by an insistence on keeping control of power generation, or open up to the private sector.

KEPCO. The Korean Electric Power Company (Kepco) offer was in the broad-based, populist mode of British Telecom. Kepco offered 21 percent of its total equity. The offering price was 13,000 won per share ($US 19.21), but for low income applications who held their shares for more than three years, the price was 9,100 won ($US 13.38). This represented a significant discount of 30 percent.

"Ordinary" applicants (those not considered low income) were allocated 2 percent of the shares, low income applicants who could sell their shares at any time were allocated 23.4 percent, and low-income applicants holding shares for more than 3 years were allocated 54.6 percent. The employee stock ownership plan (ESOP) was allocated 20 percent.

The offering period was from May 27 to June 1, 1989. The share offer was oversubscribed. In all, there were an astonishing 6.7 million subscribers to the share offer, who paid $1.9 billion for their shares. The shares were listed on August, and rose to 22,000 Won ($US 32.74). An underwriter was used, but it had no power to set the terms of the offer. KEPCO is now by far the largest company in terms of market capitalization on the Korean Stock Exchange.

Companies in other industries which are good candidates for privatization and which can add depth and stability to the stock market include cement companies, steel companies, petroleum and refining companies, breweries, airlines and hotels.

4. Privatization can help to attract foreign investment which strengthens securities markets.

Privatization also has important links with foreign investment. Though not a panacea, foreign investment can bring to a developing country needed capital, technology, market access and management expertise.

Privatization is an obvious vehicle to attract foreign investment. Foreign investors are usually an important source of demand, given the limited local absorptive capacity of many developing countries to buy large state enterprises. Foreign investment is driven by perceptions of risk and return. It is generally easier, and less risky, to attract foreign investors to companies which already exist, rather than setting up new enterprises.

Foreign investment can come in two basic forms. One would be from other companies in the industry that are interested in expanding into new markets. They would be interested in acquiring enough shares to influence management. Attracting this kind of foreign investment is an important feature of many privatization programs, including Sri Lanka, Mexico, Argentina, and Chile.

The other kind is foreign portfolio investment. Fund managers at the institutional investors in developed countries are attracted by the high returns and low correlations with developed markets (which lowers their overall portfolio risk.) Managers of these funds are directing billions of dollars to emerging markets. Essentially passive in nature, these investors are looking for attractive dividends and capital appreciation, but not control over management.

Benefits of foreign portfolio investment for the emerging market include an increased demand for equities, which may lead to new issues by existing companies, and new listings. They are also an additional source of demand for state owned enterprises up for privatization. They can help to make the markets more efficient by buying undervalued shares and selling overvalued ones. Foreign portfolio investors usually demand for better information, which may improve local investment research abilities, accounting standards, audit procedures, and disclosure requirements.

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A WORKING PAPER

Securities Markets and Privatization

Michael P. McLindon

December 1992

Scope of Work

[While the role of the advice provided was "ad-hoc," there was still a fairly specific initial agenda. While all of the items received some attention, item number 4 came to dominate in view of the Minister's and Ministry's requests for specific activities in the policy fronts of industrial policy, privatization, foreign investment, trade, and inter-enterprise arrears.]

1. The Adviser will make a rapid assessment of the adequacy of existing arrangements for acquisition and dissemination of economic statistics and related information in the Ministry of Economy. If this quick review indicates the need for revision and strengthening of these arrangements, the adviser will draft terms of reference for a study by a specialist in economic statistics and information management. The study, if needed, should be action-oriented; it should include a detailed plan of action to remedy observed deficiencies.

Action: A quick review indicated that while this was a concern, it is already being addressed on an ongoing basis at several levels. Economic statistics and information is primarily developed and disseminated by the Slovak Statistical Office. As such, it is understood that it is currently receiving assistance from the IMF (with the World Bank possibly to contribute also) through a detailed workshop on the national accounts and financial programming, as well as on-going technical assistance. The Slovak National Bank (i.e. the central bank) is also receiving assistance from the IMF to improve its statistical gathering processes and back office operations.

2. The advisor will assist the staff of the Foreign Trade and Investment Department of the Ministry should they decide to undertake an evaluation of existing policies and institutions for export and investment promotion. This evaluation will presumably be in the nature of a rapid assessment, aimed at synthesizing existing studies and reports, identifying major problem areas and providing a foundation for future analyses of greater depth.

Action:

--Briefings with Minister Cernak on advantages of devaluation, and means of promoting foreign direct investment.

--Worked with foreign investment unit of MOE. Provided information on corporate income taxation and foreign direct investment in Central and Eastern Europe. Meetings with IFC and FIAS; developed with unit a request for a diagnostic study with this unit. Discussions and draft of policy points on foreign investment.

Meetings with head of American-Slovak Fund on impediments to foreign investment and business development. Briefing for newly arrived advisor to SNAFID (Slovakia's foreign investment promotion agency) on the economy, and prospects for foreign investment.

--The request for an IFC-FIAS diagnostic study was responded to affirmatively by the IFC, and led to a mission in late April. Advisor briefed IFC-FIAS official and helped to identify key contacts to further assignment.

--Discussion with USAID sponsored environmental advisors on private sector approaches to environmental management, and on status of limitations on environmental liability for pre-existing problems, as a means to encourage foreign direct investment in certain sectors, especially the chemical sector.

--Memo to Minister with recommendations for approaches to trade policy.

3. The adviser will examine existing data and analyses for the industrial sector, and determine what guidance they give for determining Slovakia's comparative advantage in industrial production. Some Slovak officials believe that the country's industrial sector produces too broad a range of outputs--too many types of machinery for example. It is therefore not sufficiently specialized to be competitive in world markets. The adviser will assess the validity of this and other prevailing views on industrial policy, defining the scope of work for any further studies that might be called for.

Action:

--Preparation of report analyzing the Ministry's industrial policy paper, with suggestions on how to modify and strengthen it.

--Follow-up discussions on industrial policy paper with staff at Ministry of Economy. Meetings with Mr. Kosir (Center for Strategic Studies) and Mr. Kozlik (Prime Minister's Office) on role of industrial policy in overall economic policy. Industrial policy paper approved by Economics Council in late February.

As for comparative advantage, a rough approximation of comparative advantage can be gathered from the financial data on the enterprises, the level of subsidies (presence or absence), and the level of exports to western markets. The advisor examined in part the MOE's data base of 419 enterprises, and this provides a useful beginning.

Of course, there are significant accounting differences between current regulations and practices in Slovakia, and western generally accepted accounting principles. Under Slovak regulations, certain fundamental Western concepts are not applied, namely: a matching of costs and revenues, an assumption of going concern, the accrual basis of accounting, profits included only when realized, foreseeable liabilities and losses are reported, accounting principles are applied with prudence. In addition, historical costs, expenses and revenues have been controlled by the government are were not necessarily indicative of free-market or world prices of goods and services. Many goods or services were subsidized and therefore, the prices which have been recorded in the financial statements may not be indicative of the true, free-market costs.

Rather than try to determine comparative advantage, a part of the advisor's ongoing dialogue with the Ministry was to encourage it to privatize as many state owned enterprises as rapidly as possible, reduce and eliminate subsidies to enterprises , and develop suitable trade policies through a flexible exchange rate, and low and level tariffs. With this relatively more level "playing field" comparative advantage would be determined by the relative efficiency and industriousness of individual entrepreneurs and enterprises.

4. The adviser will be available for consultation with staff of the Ministry of Economy, and will attempt to perform such ad hoc assignments as may be given by the Minister or the State Secretary.

Action: In view of the Ministry's needs and requests, in the areas of industrial policy, privatization, foreign investment, trade, and inter-enterprise arrears, this item was became the major emphasis of the assignment. Details of activities and outputs are discussed and described above in the introduction and summary of the final report, and the main reports, papers and memos generated under this item are included in this final report.

CURRICULUM VITAE

Michael McLindon is an economist and privatization and capital markets specialist with over 15 years of experience in the emerging market countries of Asia, Latin America, Africa and Europe. He has worked with numerous governments to organize privatization programs, identify candidates, and structure and implement transactions in the airline, banking, power, telecommunications, infrastructure and tourism sectors.

In the capital markets area, he is an experienced investment analyst, and has worked with governments to develop stock markets through policy and institutional changes to encourage companies to list, develop local individual and institutional investors and attract foreign portfolio investors.

During the last three years, he has advised and undertaken research on privatization and capital markets in Korea, Sri Lanka, the People's Republic of China, Thailand, the Cote d'Ivoire, Senegal, Bangladesh, the Dominican Republic, Zambia, the Philippines, and Slovakia. In 1989, he advised the Capital Group, the Los Angeles based investment management firm, on making portfolio investment in five Caribbean basin countries and in Turkey.

He was a member of the U.S. foreign service (USAID) from 1983 through 1988 as an economist, serving in Washington D.C. and Jamaica. Earlier in his career he worked as an economic consultant to the U.S. Department of State in Zaire, the World Bank, and the governments of Cameroon and West Germany. A former Fulbright Scholar, he has a Ph.D. in international economics from the Fletcher School at Tufts University, and is a Chartered Financial Analyst (CFA). He is fluent in French and German, with a working knowledge of Spanish and some Russian.