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PRIVATIZATION

Financial Choices and Opportunities

Amnuay Viravan

INTERNATIONAL

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Privatization

Financial Choices and Opportunities

Amnuay Viravan

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PREFACE

The International Center for Economic Growth is privileged to publish *Privatization: Financial Choices and Opportunities*, the 1991 Per Jacobsson Lecture, as the thirty-first in our series of Occasional Papers, which feature reflections on broad policy issues by noted scholars and policy makers.

Dr. Amnuay, a distinguished scholar and the former minister of finance of Thailand, and currently a member of ICEG's Board of Overseers, offers an overview of the conditions vital to the successful privatization of industry in developing countries. His discussion focuses on the necessity of shared effort among the people and governments of the developing nations and the donor countries. To Dr. Amnuay, the desire and willingness to privatize—on the part of both the public and the private sector—is as crucial to a successful privatization plan as the capital. Though the developed nations and international organizations involved can offer support, the efforts to privatize must come mainly from the developing countries themselves.

This subject has become increasingly important in the economic progress of developing countries throughout the world. ICEG is committed to the encouragement of research and discourse relevant to policy making and is pleased to offer this contribution. We wish to thank the directors and officers of the Per Jacobsson Foundation for their kind cooperation in making this publication possible.

Nicolás Ardito-Barletta
General Director
International Center for Economic Growth

Panama City, Panama
April 1992

ABOUT THE AUTHOR

Amnuay Viravan has been executive chairman of the Bangkok Bank, Ltd., since 1983 and is chairman of the National Economic and Social Development Board, the top planning agency of the government of Thailand. A graduate of Chulalongkorn University, Bangkok, he received his M.B.A., his M.A. in economics, and his Ph.D. in business administration from the University of Michigan.

Before entering the private sector, Dr. Amnuay served as secretary general of the Board of Investment, permanent secretary of finance, and minister of finance for the Government of Thailand.

Dr. Amnuay is a governor of the East-West Center in Hawaii and a member of the Visiting Committee of the Graduate School of Business Administration at the University of Michigan. He chairs the Institute for Management Education for the Thailand Foundation and serves on the Board of Overseers of the International Center for Economic Growth.

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AMNUAY VIRAVAN

Privatization
Financial Choices and Opportunities

Mr. Chairman, distinguished guests, ladies and gentlemen,

I am greatly honored by the invitation from the Per Jacobsson Foundation to address its prestigious forum today. I am also grateful to the Thai Bankers' Association, which is kindly cohosting the 1991 Per Jacobsson lecture series and has helped make all the necessary arrangements. More important, I am delighted to have this opportunity to extend on behalf of my compatriots our warmest and heartiest welcome to the distinguished participants of the annual meetings of the International Bank for Reconstruction and Development and the International Monetary Fund in Bangkok.

It is a pleasure for me to accept the privilege of choices given to me by the foundation, by selecting "Privatization: Financial Choices and Opportunities" as the topic of my presentation. It is my conviction that privatization, loosely defined as a process of converting or transforming state enterprises totally or partially into private organizations, should gradually become an integral part of a development process on a global scale. It could even become crucial to many countries in their development efforts in the next several years.

The Triumph of Private Enterprise

We have already witnessed, since the beginning of this decade, the great triumph of democracy, capitalism, and free-market economies and the fall of communism and centrally planned economies. The triumph and fall were not totally unexpected, but the rapidity of their evolution did indeed surprise most of us.

The dismantling of the Berlin Wall in 1989 signaled an end to the Cold War and a beginning of a new economic order in which centrally planned economies and public enterprises are giving way to market economies and private initiative. In the case of Germany, the reunification process almost immediately integrated and transformed a socialist economy to a capitalist society. While the transformation process is still a long way from completion, the effort has given so much hope and expectation to the countries of Eastern Europe that they too are making dramatic changes in political ideology and economic policy for a market economy.

We see Eastern European nations—Bulgaria, Czechoslovakia, Hungary, Romania, and Poland—restructuring their economies through privatization and foreign investment. The conversion process in Eastern Europe, turning state-owned enterprises into private organizations, will involve nearly twenty thousand entities with assets valued at over $100 billion.

The failed coup in the USSR has obviously accelerated the destruction of the communist empire. The new Soviet leadership, which supports political independence of the Soviet Republics, will most likely pursue, with far-reaching results, a market-oriented development policy and a policy to redeploy resources from military and defense to economic and social development.

Some Latin American countries, which damaged and stagnated their economies by public mismanagement, incurring heavy external debts and hyperinflation, are beginning to find their way back through economic liberalization, deregulation, denationalization, and privatization.

The People's Republic of China and socialist nations of Indochina are seriously talking about the market economy and opening up their borders for trade and investment with their neighbors and the Western world.

The newly industrialized countries and developing nations of Asia, or more specifically the ASEAN (Association of Southeast Asian Nations) countries, are demonstrating to the entire world the increasing importance of private enterprise in trade and investment, which makes the region the fastest growth area of the world.

Privatization has appealed to or become an economic necessity not just to the socialist or developing nations of the world. In fact, the developed and industrialized countries, such as the United Kingdom and Japan, have come close to perfection in the art of privatization, and have demonstrated to the world how privatization can be successfully modeled to achieve the desired results.

Since 1980 the United Kingdom under Prime Minister Margaret Thatcher reportedly privatized over thirty state enterprises involving 900,000 employees and raised $75 billion for the treasury. The government turned over to the private sector a wide range of economic activities, including water, gas, electricity, telephones, steel, and most transportation. The privatization program converted a $4.5 billion annual loss in 1979 into a $3 billion annual gain currently in new tax revenues. The privatized companies are now operating with greater efficiency and with improved rates of return on capital and, in many cases, with lower prices for the public. It is claimed that British privatization has benefited the state, the consumer, the worker, and investors alike.

Japan, a country with a traditionally strong private sector, has also found privatization to be a desired instrument to sharpen its competitive edge. It has privatized three major state-owned enterprises in railways, telecommunications, and tobacco with outstanding success. The Japanese experience is unique, however, for the government does not really have the financial need to privatize. So it has adopted the policy of privatizing the management first and divesting later when the assets become more valuable with improved operating results. Japanese privatization has also benefited the government in terms of greater revenue, the consumer in terms of lower costs and better services, the employees in terms of better pay and welfare, and most likely the new investors when the stocks are offered to the public.

Expanding the Scope of Privatization

Privatization has apparently gained such wide acceptance today that it is no longer a political issue; it remains, however, a strategic issue, a choice which has proved much more attractive in the overall process of national development.

The transfer of economic resources through privatization during the 1990s will be so great that it will dwarf the privatization efforts in the 1980s. Already, economic managers are referring to a potential privatization value of $200 billion in Asia alone during the next five years. Eastern European nations are also looking for buyers of state-owned assets worth over $100 billion. The USSR has indicated its desire to privatize assets worth as much as Rs 300 billion or $80 billion at the current exchange rate. As the media have it, privatization in the 1990s could indeed be the sale of the century.

The 1980s may have been named the decade of the merger and acquisition, leveraged buy-outs, and junk bonds, but the 1990s are likely to be known as the decade of privatization and market economy. The winds of change are blowing throughout the world. Privatization is being swept to the fore, and this watershed should provide marvelous opportunities for investors.

Success and Failure

Now we come to a very important question. Privatization often succeeds in the developed world, but in the LDCs (less-developed countries) it frequently fails to meet expectations. Why should this be?

First of all, in the developed nations, governments are committed to privatization and are clear as to their objectives. In contrast, in the less-developed world, governments tend to lack the political will, and their objectives are often confused and in conflict. In order to commit ourselves strongly to privatization, we need to be clear in our objectives as to why such-and-such a state enterprise should be privatized. If privatization leads to greater concentration of wealth and turns a state monopoly into a private one, and if it becomes a tool for political favoritism, it would obviously fail to achieve the desired objectives.

Then there is the "paradox of privatization." Governments usually wish to sell loss-making enterprises for which there are no buyers, and investors would normally like to buy profitable enterprises with which governments are reluctant to part.

Next is pricing of assets, which is sometimes unrealistic in terms of their value and potential earnings. Investors naturally expect to enjoy dividends and capital gains from their investments. It is not uncommon that governments tend to be conservative and price the assets too high in order to avoid negative political consequences.

Management is another crucial factor which makes a difference. Investors would always look for greater efficiency from better management and less bureaucratic control. Privatization without accompanying changes in business and managerial environment is not likely to succeed. The management factor would obviously be considered most vital for future growth and earnings of the privatized enterprises.

Finally, the underdevelopment of capital markets in the LDCs is a limiting factor in view of the scope of privatization and is often a major cause of failure. Equity in state enterprise assets must be easily marketable, and one needs a sufficiently sophisticated capital market with good depth to ensure such a feature.

Feasibility of Privatization

Privatization is bound to mean different things in different parts of the world. In the West and Japan, privatization is something of a luxury that is well affordable in terms of both time and funding. In the post-socialist world it is a vital necessity, but time and funds are desperately short. Privatization in East and Southeast Asia and in Latin America lies somewhere in between, being very desirable but not vitally essential, and affordable given the will and the skill.

In other words, privatization in the advanced countries puts the finishing touches to already efficient market economies; in Eastern Europe and the Soviet Union (or what is left of it), privatization creates the basis for an as yet nonexistent free market; in developing Asia and Latin America, where market economies are already in place, privatization means a huge leap in efficiency and credibility, the key to economic development.

In terms of feasibility, privatization in the West has few constraints; in the former Soviet bloc, however, the constraints are formidable, for despite the will to privatize there, who wants to buy into technologically backward and politically and economically unstable enterprises?

Privatization in Southeast Asia is more difficult than in the West for a number of reasons, for instance, the scarcity of domestic savings, the shallowness of stock markets, and, in many cases, a scarcity of managerial skills. On the other hand, privatization in Southeast Asian countries is very feasible, given their market economies, the openness of these economies to the rest of the world, and a ready access to world capital markets.

Motivation for Privatization

Various governments and various nations may privatize their enterprises for many different reasons. Eastern Europe would be primarily motivated by political ideology and a policy shift toward a market economy. Latin America would look toward privatization as a means to lift their economies out of stagnation and hyperinflation as well as to reduce their external debts, which cannot possibly be handled otherwise. Japan and East Asia would be more concerned with the improvement of efficiency and much less with financial considerations. The United Kingdom, on the other hand, would adopt privatization policy both for a stronger fiscal position and for greater managerial efficiency.

In Southeast Asia, Indonesia, Malaysia, and Thailand are supporting privatization policies mainly for a reduction of the fiscal burden created by state enterprises, to do away with political interference in management, and to improve efficiency. Privatization in these three countries would also enable the private sector to participate in investments in economic infrastructure, thereby accelerating their expansion programs and helping to redeploy the limited national resources for much needed social development. The Philippines, with an economy long mismanaged by the previous political regime and devastated by a series of natural calamities, would need privatization to lower budgetary and payments deficits and to mobilize resources from the private sector for economic and social development. Singapore, on the other hand, already enjoys a strong revenue base and a high level of efficiency in the public sector but needs to privatize in order to increase the supply of equity stock in the capital market to absorb the fast-expanding flow of national savings.

Privatization Movements in ASEAN

It would be of some interest at this point to take a brief survey of the privatization movements in the ASEAN region. As in most other regions, ASEAN nations seem to have an unequivocal policy to support the private sector as an engine for economic development. The original five ASEAN countries—namely, Singapore, Malaysia, the Philippines, Indonesia, and Thailand—share the same conviction that privatization and a stronger role for the private sector would help accelerate the national development process.

All of these nations have incorporated privatization programs in their development plans and have attached high priority to their implementation. Although privatization has been initiated in various ASEAN countries since the early 1980s, the process was rather slow in general. It is not until recently that the national efforts have become more intensified, and momentum is being gained.

Among the major factors supporting the ASEAN privatization process are

- the ever-increasing degree of interdependence in the global economy, which makes national competitiveness a prerequisite for sustained economic growth;

- rapid changes in technology and the greater need to harvest the benefits of available technology, which tend to make bureaucratic control and direct government involvement obsolete and incompatible with the competitive requirements in the national economy; and

- a private sector, gradually strengthened in terms of both management and financial resources through decades of rapid economic growth, which is eager and willing to play a greater development role in all areas of economic activity.

Singapore, a city-state and a newly industrialized economy, has led the way and is considered more active in privatization. There were fifty-six government-owned companies in Singapore in 1985, of which twenty-three have been recommended for privatization by a government-appointed committee. At least twelve government-owned companies have been listed in the Singapore stock exchange, paving the way for fast privatization.

In Malaysia, the government formulated the Privatization Action Plan identifying 246 government-owned entities for privatization. Of these, sixty-nine are planned for privatization in two years and 107 within five years. By the end of 1990, thirty-seven entities had already been privatized in varying degrees.

Indonesia has reviewed the performances of its 189 state-owned enterprises and found that ninety-two are considered unsound and thirty-seven less sound. The remaining sixty are classified as sound or very sound. As an initial step, Indonesia plans to privatize fifty-two of its unsound enterprises during the next few years.

The Philippines, the ASEAN member that has been subject to the greatest misfortune, has been in the process of reprivatizing the assets confiscated by the earlier regime as well as privatizing other government assets to raise funds for the soaring economic and social needs and the mounting external debt service.

The Philippine government formally launched a privatization plan in December 1986 and has since then disposed of the assets and equity of over three hundred state-owned enterprises to the private sector. The extent of privatization is relatively small, however, and much more has to be done to come anywhere close to the planned target. Among the major organizations earmarked for privatization are the Philippine National Bank, Philippine Airlines, and the National Steel Corporation.

Thailand currently has sixty-one state enterprises. Most large state enterprises are responsible for public utilities and infrastructural development. During the seventh five-year national development plan, it is estimated that $50 billion will be needed for expansion of infrastructural facilities. Privatization policy has therefore been adopted as a means to mobilize financial and managerial resources from the private sector to implement the development plan.

Major state enterprises, which have already been partially privatized or will be privatized in the near future, include the telephone organization, which is granting a concession for a three-million line telephone expansion program, worth $4 billion, to the private sector; the Expressway and Rapid Transit Authority, which has established a joint venture with a private company for the second-stage expressway expansion worth $1 billion; and Thai Airway International, which will publicly issue a series of new capital in the Stock Exchange of Thailand to mobilize equity funds from private sources to help finance its $4 billion expansion program in the next five years.

Financial Availability

Needless to say, the spectacular offer to the private sector on the world scene exceeding $380 billion in value presents an opportunity—though admittedly one fraught with risk—for profit-minded investors. Nonetheless, where will all the needed funds come from?

In financial terms, developed countries will experience the least difficulty in launching their privatization programs, followed by the dynamic Asian countries. Meanwhile, countries bled dry by capital flight, the LDCs, and the post-socialist countries will face the most difficulty.

The countries in the last three categories are also normally the ones with a large public sector. Their financial problem is more complicated as domestic savings fall far short of demand. In the countries experiencing capital flight, the situation may improve if they succeed in reversing the direction of the flow of funds. However, as things stand, local sources prove inadequate in most developing and post-socialist countries.

Thus, these countries will have to look beyond their borders and seek funds in the world capital market. Even the developed countries and the dynamic Asian countries themselves have to rely to a varying degree on foreign sources to finance their privatization programs. To make matters worse, the world is facing an increasingly tight credit situation. A credit crunch has developed in Japan, the USA, and unified Germany, the major sources of funds for the world.

The USA, which has accounted for 40 percent of total global credits, is still plagued by the twin deficit problems of a weak economy and becoming a net borrower. Japan, which captures another 30 percent share of total world credits, is making preparations for its banking sector to meet the Bank for International Settlements (BIS) capital adequacy requirements in the coming year. And unified Germany is burdened by the need to provide large and growing assistance to the eastern part of the country. On the demand side, additional demand for funds for economic rehabilitation in Eastern Europe and the Soviet Union and for reconstruction in Kuwait and Iraq in the years to come are expected to be huge.

The obvious financial imbalance in the world in the 1990s, the decade of privatization, implies that potential investors or the buyers of governmental assets would be in the driver's seat, being able to pick and choose the offers which are most attractive. In other words, we can expect a buyer's market to prevail in the global privatization game over the next several years.

The imbalance also implies that the governments which are successful in privatization will have to design their privatization packages for sale in a more attractive and more realistic manner. This is so because privatization has become and will become more competitive in attracting capital funds both from domestic and external sources. As already stated, the key features which will rank high in potential investors' considerations would be pricing, managerial ability, and the marketability of the privatized assets.

Supporting Policies for Privatization

Obviously, political will and political decisiveness will always be necessary, but never adequate, conditions for successful privatization. Developing a favorable environment for privatization is exactly the same as developing a proper climate for investment. Private sector participation must be truly welcome, and governmental interference and bureaucratic red tape must be reduced to the minimum.

There are of course a great many factors affecting investment climate and privatization feasibility, but foremost among them are political stability, availability of professional managerial skills, freedom to manage without political interference, growth potential of the national economy, and depth of the local capital market.

Both foreign and local investors consider political stability and consistent, favorable economic policy for private enterprise as prime prerequisites for long-term capital investment. Changing and unpredictable policies and practices would greatly increase business risks and inevitably scare away potential investors. Political stability and predictable economic policies have been the most important supporting factors for the economic success of the newly industrialized countries of East and Southeast Asia.

Economies have to be efficiently managed in both the public and the private sectors. The growth and prosperity of an economy does not come about just because of natural endowments or availability of financial resources. There are too many resource-rich countries in the world that make no headway in their development process. It follows that a successful privatization program requires a strong cadre of professional managerial skills in the private sector to accommodate the conversion process. In other words, lack of private managerial capacity or partial divestiture of state enterprise without managerial improvement would have very little, if any, impact on national economic efficiency.

Professional management needs to be consciously promoted and developed through academic training and a proper business environment in which governmental intervention is kept at a minimum level. Business managers will be at their best in a competitive atmosphere when they have to deal with constant changes in market forces, consumer preferences, and technologies, with the government acting more as promoter and facilitator. It is imperative that private business be given the maximum degree of freedom to manage and excel in a competitive environment as is the case in most OECD (Organization for Economic Cooperation and Development) and industrialized countries.

Privatization is a long-term process and needs to be given a long-term time frame so as to bring about lasting national development benefits. The sale of government equity or assets to the private sector cannot be undertaken on a nominal basis without real improvement in management and operating performance. Failing to achieve the long-term objectives in terms of better output and efficiency would mean failure and public disappointment. Consequently, privatization in an economy with a strong private sector and strong growth potential stands a much better chance of success.

Another key factor in the privatization process is the capacity to mobilize savings in the national economy. We all realize that we do need funds from external sources to support the privatization programs of developing countries, at least to some extent. But the more we can depend on domestic sources of savings, the better results we can expect to achieve. To ensure a substantial source of domestic savings and the likelihood of ownership dispersion on the widest possible scale, we obviously need great depth in the local capital market, considering the financial scale of privatization.

A Prescription for Privatization

The Cold War has ended, and the communist empire has crumbled. We have also recently witnessed the first bold step in unilateral nuclear disarmament by President George Bush and the subsequent response of President Mikhail Gorbachev, which drew praise and support from political leaders all over the world. The nuclear disarmament process is likely to end the arms race and could significantly divert the national resources of most nations from defense to economic and social development. It should also, in the medium and long term, accelerate growth in the global economy and enhance the global capacity to save and invest. This development would naturally strengthen and be compatible with the privatization process. The political aspect of privatization would also strengthen democratic society and enhance the role of the private sector in economic development. It is therefore in the interest of private investors, be they individual, corporate, or institutional, to support privatization programs.

Many investment banks and securities companies are already very active in devising privatization plans for state enterprises both as financial consultants and as underwriters. Many fund managers have also found privatization an attractive area for investment and a lucrative source of earnings for their capital. Much more can be done, however, to capitalize on the fast-expanding opportunities in the privatization process.

The World Bank, through its International Finance Corporation (IFC), which provides loans and equity investment in private sector projects, has initiated sponsorship of many investment or country funds with great success. Most notable among them is the Emerging Markets Growth Fund established five years ago with private investment participation of $50 million. The Emerging Markets Growth Fund has since expanded to nearly $800 million and provided much-needed equity investment in many developing countries.

It is strongly recommended that the International Bank for Reconstruction and Development (IBRD) and the IFC have to play greater roles in supporting privatization movements, especially in the developing nations. The IFC could invest directly in the privatized projects from its own funds and should of course initiate and sponsor more investment funds for privatization in the developing world, both in the member countries and in the socialist-turned-democratic nations. The IBRD and its developed member countries should provide technical assistance in the planning and implementation of privatization programs in the countries that need them.

Various international institutions and OECD countries should make greater efforts to assist the developing countries in upgrading their professional managerial conditions which are so vital to a successful privatization program.

It must be made abundantly clear, however, that the responsibility for success in the privatization program rests fully and solely on the privatizing nations. International organizations, donor countries, and external investors can play a supporting role but can never substitute for the necessary actions on the part of the host nations.

Already identified are a number of factors which are critical to effective privatization, namely, strong political will and unambiguous objectives, realistic pricing of the privatized assets managerial improvement and freedom from bureaucratic control, and a sufficiently strong and sophisticated capital market.

The importance of such critical factors to privatization can never be exaggerated. But it is also vital for the governments to establish privatization criteria against which the actual results can be measured and evaluated, for without established criteria we might not be able to ascertain the effectiveness of our efforts.

I strongly suggest that privatization in a democratic society must have as its primary objective a firm intention to widen equity ownership and decentralize wealth in the nation. Better income and wealth distribution have already been given highest priority among the various development objectives, and privatization should be one key measure to support such a priority.

Equally important is to ensure that privatization effectively promotes competition and sharpens the competitive edge of the national economy. In line with this objective, bureaucracy must take steps to do away with unnecessary supervision and controls to ensure the degree of independence and flexibility similar to that of a private business entity. Only in this way can privatization truly increase productivity and accelerate economic growth on a sustained basis.

Special attention should also be given to the management and employees of the state enterprise under a privatization program. It is desirable and recommended that a certain proportion of stock issue be offered for sale to the management and employees, preferably on a concessionary basis. The recommended action is not to buy support from the employed, but to be fair in recognition of their valuable contributions in building up the organization.

Mr. Chairman, ladies and gentlemen, privatization has indeed become a global phenomenon, a strategic tool for democratic and economic development, an attractive choice for promoting competitiveness and efficiency, and a viable opportunity for investors and professional managers. It is an economic conversion process which a post-socialist country cannot survive without, a developing nation cannot afford to overlook, and a developed society can neglect only at its own risk.

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