An Update on Privatization

This note is meant to update some of the happenings in Eastern Europe beyond those described in the lecture notes, and which I discussed in class. I will do this on a country by country basis.

RUSSIA:

The most popular form of privatization used in Russia is where management and workers purchase up to 51% of their company at a price of 1.7 times the book value of the company in 1992. Twenty percent of these companies are retained by the government and the remainder is offered to the populace via vouchers.

This scheme superseded that which was initially proposed (25% non-voting stock for workers) as described in the lecture notes.

Unemployment rates remain low, with registered unemployment being only 2.5%. This may be a manifestation of the fact that workers seem to exercise control over their companies.

By now, about 70% of small companies have been privatized. Fifty-five percent of these have been done through management buyouts.

The Russian scheme has been characterized by two steps. First was the voucher-based scheme, where individuals purchased vouchers for 10,000 which they would use to bid on companies. These vouchers could alternatively be used to bid on pooled voucher funds, rather like mutual funds, and there are about 400 of such funds nationally. These funds can’t own more than 10% of a given company.

The second wave in Russia was cash sales, which were needed as the government was suffering severe budgetary problems. These have occurred since 1994-5. These have not been a huge success, as there have been political constraints against letting in foreign capital which may speed up restructuring (Gazprom is a good example here). In addition, there have been constraints imposed through the institutions of sale, such as that the government requires that you put up a deposit equal to the entire cost of the firm when you are bidding. In this wave, insiders (management and workers) only get a maximum of 25% of the company.

The next deal offered by the Russians is loans-for-stock, where an investor will offer a loan to the government with a fixed rate of interest, plus you get to buy a company, where you keep 30% of the appreciation in its stock value, with the government getting the remaining 70%. These have yet to see much success.

The Banks: New legislation was passed in 1998, which split Gosbank into a central bank and 5 specialized banks, but where the government would remain a majority shareholder in each of the 5. For example, Sberbank, which is the largest bank in Russia, remains 57% owned by the government.

Corruption: this has been a big issue in the sale of large companies. A famous example is Norilsk Nickel, where there was an auction with a reserve price of $170m. Three banks bidding colluded and all offered either $170m or $170.1m. One bank, Rossiski, violated the agreement and bid $355m, but was excluded by the government, largely on a technicality.
The government has recently also made attempts to induce foreign capital into the energy sectors. However, there remain serious property rights issues, as the government passed legislation which allows them to rewrite contracts after a project has begun – plus they still own the distribution network – which has largely scared off foreign capital.

As an example, note the renationalization of Yukos. Another good example is where a 1996 agreement with Shell to explore Sakhalin Island was "rewritten" in 2005, where the government took half of Shells' 55% stake and gave it to Gazprom at a nominal price. The way they did this was by threatening Shell with a $50bn fine for environmental damage.

Despite this, some foreign investment is coming; for example, where ConocoPhillips bought 7.5% of Lukoil recently.

THE CZECH REPUBLIC

Many people perceive the Czech Republic as a front-runner for the country that has had the most successful transition to a market economy. (For example, the unemployment rate was only about 4% until recently; now it is 6.4%.) However, more careful inspection suggests some important problems. Perhaps the main problem in the Czech Republic has been the intrusion of the state in the running of private companies. The Czech state holds veto power over the choice of management. In addition to this, it remains the case that there have been almost no bankruptcies in the Czech Republic since the change to a market economy (one major bankruptcy by summer 1997). Two particular problems are cited. First, the banks remain publicly owned, and have stuck to the policy of largely bailing out companies which are doing badly. Second, the voucher scheme in use in the Czech Republic had resulted in concentration of ownership in the hands of mutual funds; however, some of the main mutual funds are run by the aforementioned banks so that they may not be doing the job that they are supposed to do.

By 1997, the ten largest banks controlled 61% of all voucher fund points, and any single bank cannot own more than 20% of a company. The problem that this gives rise to is that there are real doubts about the incentives of these banks, as they are not privatized and are very much under the control of central government. (80% of banks are in public hands; by comparison, the number in Poland is 60%.) There is also a poor secondary market so it's hard to gain control of companies. It is estimated that about 35% of loan portfolios are not collectible. There is some sign of change here; last year a 36% stake in one large bank was sold to Nomura.

There is also some "massaging" of the data on the labor market, as in East Germany. In particular, there is a lot of early retirement which is not being included in the unemployment figures. For example, from 1990 to 1993, there were 550,000 jobs lost in the Czech Republic, and unemployment rose by only 116,000. By contrast, in Hungary, 800,000 jobs were lost, but unemployment rose by 563,000. Part of the reason for the rise in early retirement is that tax rates for older workers doubled after 1992, and the "old age pension" was increased.

GNP in Poland has been growing rapidly (6.7% in 1997), while it is flat in the Czech Republic, and has inflation of 12-13%. Another piece of evidence on the difficulties faced by the Czech Republic is that direct foreign investment has been reduced by 50% since 1995.

Things appear to be changing post-1999. By 2001, about 90% of total banking assets are in the hands of foreign banks. An implication: since 1997, thousands of companies have gone bankrupt. There has also been a large jump in FDI.

EAST GERMANY

The Treuhand has by now been disbanded having privatized all but 100 of the companies that it was commissioned to do. These companies were largely sold to West German investors (often for one Deutschmark) and typically no effort was made to reorganize these companies. Unlike other Eastern
European countries, existing workers have not been offered a share of the newly privatized companies. The reason for this is that the West German government provided direct subsidies to the East through a variety of means, one of which was the 1 to conversion for the Ostermark with the Deutschmark. Despite these subsidies, you should not get the impression that the Treuhand is popular in the East, and is generally referred to as the "job killer." As an example of this dislike, note that the Director of the Treuhand was murdered.

By 1993, wages were 70% of those in the West, but labor productivity was so low that unit labor costs were 80% higher in the East. Because of these kinds of problems, employers in the East reneged on the labor contracts, which cause IG Metal to go on industry-wide strike. The ultimately caused a renegotiation of the contract, giving them until 1996 to get wages up to West German standards.

By 1994, employment was at 1.6 million, down from 3.5 million in 1990. This is evidence of the kind of restructuring that is needed in most of the Eastern European countries (though unemployment rates are down to 17.5% now).

POLAND:

Poland should probably be seen as one of the success stories, particularly for the larger companies. There remains some doubt about the importance of the National Investment Funds (as it seems that the supervisory boards in some cases are impervious to their demands), but at least there is not the workers control of the large companies that one sees in Russia. These supervisory boards consist largely of Polish academics, industrialists and former bureaucrats, which were introduced by the Polish Peasants Party. In 1996, several fund management teams were sacked by their supervisory boards over disagreements regarding large scale job cuts or unrealistic financial targets.

This issue does not seem to be the case with the medium-sized companies where 3/4 of the liquidations (the typical form of privatization for these companies) have simply been leased back to the existing workers and management.

On the voucher scheme for the NIFs, these were issued in 1996 and cost 20 zlotys; by 1998, they were trading at 150 zlotys, with a significant positive real rate of return. The 500 companies that they trade in consists of about 5% of GDP.

By now, 70% of the economy is privatized.

Poland has had twice as much foreign direct investment as Russia, and 2/3 of GNP is now in private hands. As an example of how the banking sector has problems, in 1994, the banks were bailed out, costing about 7% of GDP. By now, almost 50% of bank assets are held by foreign banks, largely through new entry by foreign banks rather than them taking over existing banks.

UKRAINE:

Under Kravchuk's early period (until 1994), not much was done, with only 10% of 80,000 targeted enterprises privatized. One way that privatization was inhibited was that he allowed workers to lease the companies that they work in. He also essentially eliminated foreign investment by charging foreigners many times the price offered to domestic residents.

After Kuchma came to power, he introduced non-tradable vouchers, where employees were given the option of buying a 51% share of their companies. By 1995, not much had been sold particularly of the large firms. However, by now there have been considerable advances made, but only in small businesses, as large businesses and agriculture remain in state hands. On the issue of corporate governance, there seem to be big problems with old management and employees continuing to hold control.
CHINA:

Most know that the Chinese economy has grown enormously since 1979, when the initial moves towards privatization were made.

Much of the attention in China has been on the industrial sector, but in truth the major changes in living standards in China have been generated in rural areas, often associated with the agricultural sector. See Figures 1 and 2.

TVEs: The main mechanism was the township collectives (or TVEs), which were initially allowed to keep surplus above their quota. For instance, in 1978, only 3% of workers had pay that depended on their performance, which had increased to 24% by 1984.

In 1979, the Chinese government dismantled its commune system, and allowed the "household responsibility system" in the agricultural sector, which results in increased efficiency in agriculture. It also gave rise to a lot of non-agricultural enterprises vis TVEs, which were owned by local residents, but were controlled by local government. Even though this form of privatization was far from ideal, it resulted in growth in this sector of 20% per annum, such that rural firms accounted for 40% of GNP in the late 1990s.

Yet expansion of this sector slowed in the mid-90s, and gave rise to something closed to true privatization, where assets were sold to private parties. However, overwhelmingly the sales have been made to existing management, with recent studies noting that roughly 90% of sales have been made in this way.

Prices for privatization are in the hands of local officials, which has given rise to enormous complaints about corruption. It is also far from ideal in that an honest local bureaucrat may know little about the true price something should be sold for.

This source of privatization has occurred at a remarkable pace, with 65% of these TVEs being privatized since 1995. Employment in this sector is now about 30% of rural employment.

Industry: Private ownership in China is now roughly 35% of GNP. There have been two main ways of privatizing assets: (i) sales of shares to managers of firms via MBOs (as with the TVEs), and (ii) sales on stock exchanges.

Most of the sales of the first type have been small and medium sized firms, with insider stakes being about 25%. In both types of privatization, the government typically retains a greater than 50% share. The government has also recently begun a policy of requiring firms to buy a "bad firm" if it is to get a good one.

To get a sense of where privatization of SOE's has happened, here is the distribution of SOES in 2002 compared to 1995:

<table>
<thead>
<tr>
<th></th>
<th>1995</th>
<th>2002</th>
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<tbody>
<tr>
<td>Large</td>
<td>8,400</td>
<td>9,400</td>
</tr>
<tr>
<td>Medium</td>
<td>38,000</td>
<td>28,000</td>
</tr>
<tr>
<td>Small</td>
<td>206,000</td>
<td>121,000</td>
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so it is largely small firms that have been privatized.

VIETNAM:

Doi Moi was the government policy that initially started privatization. Started very slowly, with privatization of revenue streams more common than privatizing assets.

It has accelerated a lot since 2002 to the extent that now 40% of SOEs are privatized. However, rather like China, the government retains 46% of shares, insiders an additional 38%, with outsiders getting 15%.
About a quarter of privatizations are "closed," meaning that no outsiders get shares. To get employees to sign up, they are given a discount of 40%.

Overall, the privatizations have increased efficiency, but not by any great extent. The reason for this is largely because the control that the government and insiders have had serves to constrain restructuring. An indication of this is that unemployment is less than 3%.

Instead, one of the primary ways that Vietnam has done so well over a long period has been investment in new private firms, which often take the form of joint ventures.

BRAZIL:

Generally seen as an example of how privatization should be done in utilities, which is a big part of Latin American privatization.

Telecom is a good example. In the 1960s, the government nationalized the telephone industry (Telebras). Performance by the company was pretty dreadful – a 24 month waiting period to get a phone, a very strange pricing system where you paid $2k to get the phone (in return for which you got ownership in the company) and incredibly low service rates, below marginal cost.

In 1995, there was a law passed to end the state monopoly, and changes were made before privatization, by increasing service charges (from about 50c a month to $12), and doubling call charges. They also made significant investment in infrastructure. Privatization began in 1997 with the development of Anatel, the regulator.

Privatization occurred by auction, but where there were 12 separate licenses (region x cellular/fixed). In each region, the cellular company had to be different to the fixed line. No restrictions were placed on foreign investment. Employees were not given stakes.

Most measures of performance are good subsequently. Prices have declined, concession agreements have been largely respected, and the regulatory agency has been independent of the government and has in one case stopped firms from increasing prices. Contracts were initially until 2005 but these have been extended by 30 years.

ARGENTINA:

Not nearly as successful as Brazil, to the extent that there have been renationalizations (water and postal services in 2003) with improvements in performance.

As with Brazil, a major reason was to reduce government debt. The sales of companies from 90-94 amounted to 9% of GNP.

Employees generally were given a 10% share. Despite this, there have been massive layoffs –amounting to about 15% of the increase in unemployment in Argentina.

Example: Entel (telecom) – Split into two companies, one for the north and another for the south. How the companies were sold off remains unclear, with many accusations of corruption. There is a regulatory body, but it has almost no power. Instead, it seems as if most things in the industry occur through a negotiation between the government and the industry.

Despite this, there have been efficiency gains. How much of this is because of increased competition from cell phones remains unclear.
Water – became Agua Argentina and sold to a French firm. Initially things went ok, with increases in investment and major improvements in water quality (to the extent that there was a notable decline in infant mortality), with investment increasing by a factor of 10.

But the industry was hit really hard by the currency crisis, as the government responded by (i) paying in pesos, (ii) freezing tariff rates in pesos, and (iii) exempting poor people from paying tariffs at all.

The firm responded to these reduced revenues by massively scaling back investments and defaulting on concession agreements. This has been a problem beyond just water. The result of this in the water industry was renationalization.

Other industries: electricity (has worked well largely as competition was written into the initial law) and airlines (a disaster, full of possible corruption).