CHAPTER VIII

PRIVATIZATION - ECONOMIC STRUCTURES IN DEVELOPING ECONOMIES

INTRODUCTION:

This chapter sets up analysis of privatization in different economic structures, based on certain premises; i) privatization has been less successful in the low-income economies, than in well developed and more diversified economies; ii) the pace of progress of privatization is largely due to changes in the structure growth and development of the economy, and iii) efficiency impact of privatization is similarly due to development of market structures and regulatory capacity. This chapter examines in Section-2: the extent to which the domestic private sector in developing countries can provide a competitive environment through which the economic efficiency gains are expected to flow from privatization or that can be realized to generate the resources as to absorb privatization sales. The study also focuses on capital markets in the privatization process, namely savings mobilization, (in section 3 through 9) disciplined on management of regulatory capacity and its likely impact on the post-privatization environment. This chapter also probes into the constraints that economic structure imposes on privatization and the feedback from privatization to these structural factors.
8.1) PRIVATE SECTOR CONSTRAINTS AND LIMITS TO GROWTH:

In this study, selected sample countries can be divided into four sets. The first is Malaysia and Jamaica which despite their differences in population size, have similar development indicators in terms of income levels, urbanization, market depth and the share of manufacturing in GDP. The second set is Trinidad and Tobago and Papua New Guinea (PNG) which are small mineral exporting economies in which the manufacturing sector accounts for a relatively small proportion of total output. The third comprises two African economies of Kenya and Malawi. Kenya is the most industrialized East African economy, while Malawi is a poor agricultural economy. Finally India and Sri Lanka both having similarities with respect to urbanization and industrialization and poor income levels. Though the selected sample of countries chosen and sub-sample sizes are small, these countries represent reasonably adequate size characteristic or arch types for many low and middle - low-income developing countries, and hence the common characteristics of their domestic private sectors go along with to explain the nature of liberalization process and privatization in many similar developing economies.
Data on the structure of the Private sector usually limited, partial, and more dependent on infrequent external analysis than on data produced regularly by state statistics bureau. As the country studies show, a large proportion of firms are small, measured by employment and turnover, and are owner-managed, with limited access to long term finance.

8.2) THE DOMESTIC PRIVATE SECTOR AND COMPETITION:

Markets are frequently concentrated, being dominated by one or more large state/owned enterprise sector or foreign owned enterprises accounting for the major proportion of output. Except in Malaysia, industrial (non-agriculture) sectors are characterized by low levels of capacity utilization (often due to foreign exchange rationing) and high levels of effective protection. In the smaller economies, the bulk of private sector employment is generated in micro-enterprises, while firms with work force of more than 50 people contain most of workforce. Firstly Trinidad and Tobago and Jamaica, study suggests that market dominance is significant in a wide range of sectors, and that dominant firms in these sectors are state-owned. In Kenya the manufacturing sector is similarly concentrated, with 50% of all firms employing less than five people, and only 10% employing over 50, while average SOE size in the Kenyan manufacturing size

The most valuable sources are World Bank Industrial sector memoranda.
is approximately 120 employees,\textsuperscript{2} while speaking about India certain sectors are reversed for the Public Sector and the dominance of SOEs are also significant.

Though not universal, SOE domination is widespread, whilst this may be expected, for example in the oligopolist transport, energy communication, and possibly finance sectors. This suggests that these economies are significantly different from those implicit in the models of competition underpricing the privatization debate. In the large countries Malaysia, and India are evidences that private sector in general is deep enough to provide a sufficient degree of competition in the industrial sectors, although even, the relative balance is still in favour of public enterprises.

The advantages of size and capital intensity as instruments for enforcing market dominance are, in many cases, compounded by the presence of interlocking directorship ones, to act conclusively. Malawi is the most extreme case with the interlocking shareholdings and between press holdings, but it is also a traditional feature in Jamaica, Sri Lanka and Kenya. In the industrial sector, divestiture of a number of enterprises is operating in similar sectors. Divestiture of these enterprises operating in similar sectors, issues together may well itself, provide the basis for a competitive market regardless of the

structure of private sector ex-ante. Similar situations exist in other sectors. For example, the simultaneous privatization and deregulation of urban transport systems in Sri Lanka and Jamaica have created efficient and competitive markets. An identical situation arises in the agricultural sector in Caribbean, where wholesale sales of land (Jamaica) and sugar plantation land (Trinidad and Tobago) could provide the basis for a competitive market.

8.3) MOBILIZATION OF DOMESTIC SAVINGS:

Another limiting factor is the extent to which private sector can generate an adequate supply of savings for investment although this issue is never directly addressed in the theoretical literature on privatization, it is clearly a necessary logically shows empirical verification and a sufficient condition for successful privatization. Savings can be generated from two sources—domestic and foreign. Savings behaviour has been at the centre of research concerning the performance of developing economies. In particular, the extensive debate on financial liberalization revolves around concerns that repressed financial systems combined with loose monetary and fiscal policies have distorted the prices of savings. In many low-income economies aggregate savings are low, poorly intermediated, and often held in non-financial forms. Moreover, financial repression has contributed to an extensive growth of capital flight, and the preference for holding non-financial assets. The domestic savings available for long-term fixed capital formation or equity
investment are thus frequently shallow. This correlates quite closely with an observed split between foreign and domestic participation in the privatization programmes.

In addition to a low average propensity to save, savings patterns of household sector are highly skewed and subject to extreme variability over time. Moreover, the domestic savings pattern in many low-income developing countries are dominated by seasonal effects and are broadly precautionary and speculative aimed at consumption smoothing in the face of very low and violently fluctuating under certain agricultural income streams rather than being long term and secular trends oriented. Such savings patterns are rarely conducive to large scale risky capital investment. There are also often marked difference in saving pattern between Urban and Rural communities. Rising incomes due to a switch from subsistence (rural) to contract-wage (Urban) structures are likely to generate increasingly higher levels of speculative savings. These conditions are likely to be necessary to ensure that there will be a sizeable degree of domestic savings mobilized for equity investment.

An additional factor worth tracing concerns the way in which the macro-economic environment influences the mobilization of savings for privatization. The environment in which privatization has been instituted in most countries has been characterized by deep economic crises, frequently accompanied by severe income compression, upward price adjustment for basic commodities, and considerable reductions in real-wages. This is indicated in Table 8.3 that indicates there is a substantial range in the levels of aggregate gross domestic savings among the selected developing countries.

Privatization is an integral element of adjustment programmes designed to rectify such macro-economic dis-equilibria, but its success is comprised by the presence of conditions which are not at all conducive to savings mobilization and equity investment. This is a paradox of privatization to face the conditions which are against its effective implementation. The reason to this trend is the foreign sector, which macro-economic adjustment would improve its relative purchasing power. The supply response of foreign capital to structural adjustment is weak exchange-rate devaluation and weak competition of the seller at combine to give foreign investors a strong advantage in taking up privatization issues. We now turn to link between the foreign and domestic private sectors.
8.4 THE FOREIGN SECTOR AND PRIVATIZATION:

If the domestic private sector cannot provide competition necessary to ensure efficient performance of former SOEs or the resources to absorb them, the requisite competition may be provided by the foreign sector, either through foreign owned companies operating directly in the domestic economy, or through import penetration. However, across most of developing countries, regulations on foreign direct investment are tight and effective protection in the most sectors is high. Recently, policy towards foreign participation has been liberalized, foreign investments welcomed only in export-oriented sectors, and direct competition with domestic producers is not widely encouraged, consequently programmes of incentives have been developed aimed at attracting foreign direct investments, which centre around export-processing zones and either incentives/initiatives.\(^5\) In a number of cases, there are structural factors which provide natural barriers to competition for the domestic economy. The most striking examples are Papua New Guinea (PNG) and Malawi, where transport costs drive a significant edge between 'f o b' and 'c i f'\(^6\) prices.

\(^5\) It is a common feature of World Bank supported Liberalization process, Mosley. P. et. al. 1991.

\(^6\) f o b & c i f : Free on Board and Cost, Insurance and Freight.
Structural constraints notwithstanding however, most countries have instituted trade and tariff reform policies aimed at the abolition of quantitative restrictions and the equalization and reduction of nominal rates, often under the auspices of World Bank lending though the level of overall protection is falling on average. The serious debt crisis faced by many developing economies limits their access to foreign savings as a source of financing investment. Consequently, the extent to which the foreign sector can provide an effective spur to competition in the domestic market remains limited. While SOE sector operating in international markets are exposed to competitive forces. Taken together these observations suggest that the domestic private sector in a number of developing countries is limited. In the context of privatization policy - that a change in ownership without both reform of private market structures and the enhancement of regulatory capacity will not generate efficiency gains is thus of prime importance in developing countries.

Though the policies of foreign participation in the privatization process are relatively straightforward the political factors of foreign participation are for good reason much more complex and even in the economic arguments for greater foreign participation are compelling. The sale of public assets and more importantly, the sale of monopoly entitlements to the foreign sector involves the transfer of control and monopoly rents from the domestic to the foreign economy. It is of little surprise then that in most countries there is an unwillingness to
sell major assets to non-nationals. This sensitivity is frequently the result of a colonial experience, and indeed localization was frequently one of the main reasons for the original nationalization programmes.

8.5) PRIVATIZATION - ROLE OF THE CAPITAL MARKET:

This section examines the linkages between the management of a programme of privatization and the Stock Markets in our sample countries. It starts with considering the extent to which the presence of the capital market assists in the Liberalization / Privatization process; how it facilitates the mobilization of savings the extent to which in 'packages' investment bundles, and also to which extent, secondary market activity values the assets and their trade-ability.

The second objective is to analyse the extent to which privatization can fulfil the objectives of capital market developments and in particular how the promotion of privatization impacts on the nature and speed of development of the capital market. This issue is rarely addressed in the literature on privatization in industrialized economies but in developing economies where privatization frequently runs in tandem with capital market development, it acquires a higher profile. We start by briefly describing the characteristics of capital markets in developing economies.
8.6) CHARACTERISTICS OF CAPITAL MARKETS:

In our study six countries have Capital Markets (namely Jamaica, Kenya, Malaysia, Sri Lanka, India and Trinidad and Tobago) while both Malawi and PNG are actively examining options for creation of stock exchanges. With the exception of Kenya, all have used the Capital Market in their liberalization & Privatization programmes, although to varying degrees. Apart from Malaysia and India, where capitalization since 1980 has consistently represented nearing 30% and 50% of GNP respectively, the capital markets in these countries are small. The depth of these markets (even including Malaysia and India) is low, especially in comparison with matured markets, and more appropriately, with the New Industrialized countries (e.g., Hong Kong, Singapore, and Taiwan etc). The record of these markets in 1980s has been mixed. In majority cases, markets have deepened especially in the latter half of the decade. Thus in Jamaica, Malaysia, Sri Lanka and India, capitalization has risen as a percentage of GNP, turnover rates have mostly increased and a greater number of stocks are traded now compared to a decade ago.

8.7) RESOURCE MOBILIZATION:

There are a number of separate issues involved in assessing the capacity of capital markets to mobilize domestic resources, the first one is search costs, the essence of the capital markets to provide the mechanism through which the aggregate demand of a large number of small buyers can be channelled into the supply of entitlements to a small number of large assets. In the absence of
such market, sellers incur extensive search costs in identifying buyers with sufficient resources and capacity to acquire the assets. Second, in cases where the distribution of wealth is highly skewed, direct sale of public assets to only agents that have accumulated resources, can exacerbate the adverse welfare effects of concentration of asset ownership. These adverse effects of ownership concentration can, without appropriate regulation, lead to situations where dominant agents / firms act to limit the economic effects of privatization in terms of pricing and production. A number of countries which do not have developed capital markets have found that the scope of privatization is limited by the inability to mobilize domestic resources from a sufficiently wide base; to avoid an increase of a capital market not only creates difficulties in the sale of large assets, but, when other types of sales occur, can lead to the exacerbation of monopoly power in the domestic private sector.

Third, capital markets can assist in eliminating one of the major barriers to fixed capital accumulation by reducing the minimum size of investment in financial assets for any individual agent, and simultaneously provide the mechanism for its readability. Privatization programmes, which claim the broadening of economic participation as one of their objectives, confront a significant barrier in the absence of a capital market. Fourth an extension of this issue is where foreign savings represent an alternative source of demand for privatized enterprises. Here the political factors of divestiture to the foreign sector are
difficult and as we have noted there are numerous have represented the only source of capital for privatization. Governments have only viewed the advantages of foreign participation in the domestic economy but not the disadvantages like dependency problems.

Fifth, Capital markets permits Govt.'s to deal with the 'lump sum' of asset sales, especially through the use of multiple tranches in the divestiture of the same enterprise. This has the benefit of reducing the demand on domestic resources by any single tranche (there by avoiding relative price changes and subsequent crowding-out) and allowing the smoothening of governments revenue, thereby avoiding losses through accidental under-pricing.

8.8.) TRANSPARENCY OF PRIVATIZATION POLICY:

The capital market can affect the management of a privatization programme. Generally, public share issues on established markets impose conditions of clarity, transparency, and consistency on the vendor. Although is not necessarily the case, since it is possible to sell assets in poorly regulated markets, repeated use of weak markets is not sustainable, especially if the participation of foreign capital is required. For example, public share issues required independent statements of valuation of firm to be sold, full disseminated information, a declaration of actual and contingent liabilities, clear statements of corporate policy and future disclosure obligations. A privatization programme based solely on direct sales can be consistent with being an 'honest broker' however it is less easy
for the government specifically to create such a reputation using this approach.

8.9) IMPACT OF PRIVATIZATION ON CAPITAL MARKET:

The principal function of capital market in any economy is to intermediate and allocate commercial risk, and this capacity will develop over time depending upon the nature of assets flows through the market. However a privatization program based on a programme of asset sales through the capital market will, in general, affect the nature of risk intermediated by the market and also the capacity with which the market manages this intermediation. It is clear that most of the effects of privatization on the development of recent capital markets are not unique to privatization per se. Privatization issues are often large in relation to other equity issues and to the market. Second the assets sold through privatization may have characteristics different from those prevailing in the market. Third privatization issues have a higher profile than other issues and tend to involve a greater number of players many of whom are new to equity trading. Fourth privatization programmes are often used as a way of stimulating other market developments such as launch of new instruments and the development of securities market regulation. These features suggest that the impact of privatization on capital markets will not be neutral and that the dynamic impact of privatization on capital market development need close attention.
Thus, to sum up, Privatization affects the capital markets in four ways:

a) it increases the volume of equity listed on the market, b) it alters the number and type of players on the market, c) it impose demands on the technological, regulatory and operational capacity on the market, d) it will constitute a significant intervention by the government in the capital market. However, all these issues have important short-term implications for capital development.

In the chapter we have presented the interactions between the structure of the private sector, the capital market, the regulatory regime and the implementation of the privatization. Capital markets are generally small and their absorptive capacity is limited, while their capacity for efficient and credible regulation is weak. While it is the case that there are feedback effects from privatization to the development of the private sector, to the deepening of the capital market, and to the enhancement of regulatory capacity in the short-run, the dominant effect is from the structural constraint to the nature of the programme. The lifting of these constraints represents a goal of the development process in general, rather than merely an impediment to the privatization process in particular and it is no accident in the countries which have run successful programs, namely Jamaica, Malaysia and India are on most of the measures better advanced than those where the programmes have been stumbled such as in Kenya, Sri Lanka, Malawi and Papua New Guinea.