

# Capital Market Development and Privatization

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THE task to make inroads on poverty is formidable, and constraints are too many and priorities are often inconsistent. With the restoration of democracy the age of deprivation must end. Developmental activities to promote growth and poverty reduction must start and with a big bang.

Today country, in her pursuit to combat poverty, is not all alone. Favourable international climate is there for development. The world is becoming more and more interdependent, and the industrial countries are showing more and more interest to help the developing countries in their developmental activities. Nevertheless, the future of a country is in her own hand. The key to successful development is the correct domestic policies. With strong and sustained reforms, the pace of development can be substantially increased to lift millions out of poverty.

A market friendly approach, in which the Government allows the markets to function well and concentrates interventions on areas where markets prove inadequate, can show success in promoting economic growth and poverty reduction. The opportunity for rapid development is greater today than at any time before. International links, in the form of trade and flows of information, investment and technology, are stronger now than forty years ago, says World Development Report-1991. Medicine, science, and engineering have all made great strides; the benefits are available worldwide.

Succeeding in development is indeed the most pressing of all challenges that now confront the human race. Strategies in which governments support rather than supplant competitive markets offer the best hope for meeting the challenge of development. opines the World Development Report-1991.

In two-fold strategy for reducing poverty, the first necessity is to promote growth that will generate income-earning opportunities for the poor. And growth is possible through rapid industrialisation. For rapid industrialisation the country needs a sound and effective capital market.

Capital market is an important vehicle for supporting and sustaining privatization activities. Privatization can be thought of in both (1) structural and (2) policy-making sense. Structural privatization includes the full range of options the Government may take to (1) reduce government control or eliminate ownership and (2) increase the role of private sector and market forces. These options run the gamut from shifting a government operation to a statutory body operating under the direction of a semi-autonomous Board of Director (but still owned by the govt.) to full divestiture or selling of a company's equity or assets. A vigorous private sector means reducing government control on the market and increasing market forces. Government regulatory policy must also play the role in fostering privatization by making the economy more private; demonopolising sectors, eliminating subsidies etc.

In the country state owned enterprises have grown both in number and size, and they have direct access to both national and international financial markets. Growth of inefficient state owned enterprises has become a drain on national economic resources. Most of such enterprises would be profitable if they are managed and owned by private investors. Today in many countries of the world the trend of privatization has substantially increased because of (1) an increasing recognition of the efficiency of the private sector and its management proficiency, and (2) the need to raise govt. revenues for reduce subsidies.

One of the key barriers/impediments to privatization is the lack of a functioning capital market. Widespread ownership of divested companies (main aim of privatization) would never be possible without an efficient functioning capital market. Capital market and privatization activities reinforce each other.

Impediments to the orderly development of a securities market are many, and the major ones are: Lack of political and social stability, lack of free market ideology, hostile economic policy to free market mechanisms, inappropriate tax/regulatory incentives, insufficient supply of securities, absence of financial intermediaries, lack of savings etc.

Political and social upheaval contributes to a decline of the securities market. Free market ideology and economic policy help the securities market grow. Private sector's growing role in the economy has a positive effect. The securities market will be threatened if policies hostile to free market mechanisms dominate the economy. Tax incentives can be used to influence the devel-

opment of the securities market. Investors are aware of after-tax returns of various financial investments, and hence tax implications play an important role in the way they allocate savings between debt, equity or non-financial assets. A functioning securities market depends on a continuous supply of securities.

In Bangladesh the growing investor awareness (as demonstrated through ICB's array of instruments), and Life Insurance Companies, Pension Funds, Provident Funds exhibit tremendous potentialities for investment in securities market.

Investment Corporation of Bangladesh (ICB) and Dhaka Stock Exchange (DSE) are the two major institutions in the country dealing in securities. They deserve closer attention from the government to strengthen their activities.

Privatization and the private sector can be a powerful generator of economic growth, and a growing number of governments are planning to promote their private sectors and divest their state owned enterprises. Most governments in the developing countries today, however, are facing problems implementing privatization because their existing

capital markets cannot provide effective means of support for divestiture and risk-financing transactions. In Bangladesh the growing investor awareness among prove the need for a strong functioning securities market, and a powerful private sector. A capital market already exists in the country, and to develop it well and proper the weaknesses of the institutional infrastructure deserve a closer look for appropriate remedial measures. In existing institutions and the financing alternatives, the supply and demand of securities, the tax laws, the disclosure and regulatory environments, local staff training in developed financial centres and all need to be looked into.

Privatization enhances supply of securities, and to make the government's privatization programme a success enough investments would be required. The removal of prohibitions on foreign investors, which should expand demand and increase the level of activity in the capital market, deserves government's attention. Foreign portfolio investors supplement rather than replace domestic shareholders, as the foreign investors would probably prefer to buy primary issues of stock in a proven company, than to buy in the

secondary market. Additionally, foreign portfolio investment brings with it the capability of improving technical knowhow within the financial sector as a whole and thus provides an improved perspective for national planners as well as domestic investors to measure relative efficiency of different units in their company.

In its privatization programme the government is likely to encounter a number of political, management and financial barriers. One of the most popular, and effective techniques — the Employee Stock Ownership Plans, if properly designed and implemented, can help to overcome all those barriers. Workers and their unions would often resist privatization because public sector jobs are generally more secure, and may be a few political leaders would also be unwilling to risk the wrath of party workers, whose labour incomes would be jeopardised by privatization. The central premise of Employee Stock Ownership Plans is: ownership sharing, profit sharing, and participatory management. And through this scheme workers would get economic justice, which is an essential

pre-condition for social harmony, self-determination and political democracy.

British experience would be of immense help to plan and implement the country's privatization programme successfully. One of the most controversial aspects of their privatization programme had been the pricing of the shares of the companies, offered for sale. The cases of British Telecom (BT), the Trustee Saving Bank (TSB) and British Airways are worth mentioning, where large and immediate profits had gone to the individuals and institutions fortunate enough to be allocated shares, and the government suffered losses to the tune of hundred of millions of pounds despite spending large sums of taxpayers' money on 'underwriting fees' and on 'advertising new share issues'.

Pricing a new issue is often a complicated and difficult task and more so to strike a balance. Underpricing leads to revenue loss, windfall profits and arbitrary redistribution of wealth, but overpricing on the contrary may lead to undersubscription.

In Bangladesh fresh issues are made at stated/par value in

view of the Capital Issues (Continuance of Control) Act, 1947. In case of right issues, shares may be allowed to be sold at a premium to be determined by the Controller of Capital Issues. To issue shares at a discount, Section 105A of the Companies Act-1913 makes the following provisions:

\* Issues of shares at discount must be authorised by a resolution duly passed in a general meeting of the company and must also be sanctioned by the court, and not to exceed 10% in any case.

\* such issue must be made within 6 months from the date of court's sanction or within such extended time as the court may allow.

In its privatization programme, the British government sold state owned properties to public by (1) an offer for sale, (2) tender offer and (3) combination of both, in 'an offer for sale', the government invited applications for shares at a set price. In 'tender offer' bids for shares, above a given minimum tender price, were invited. In case of (1), rationing scheme and in case of (2) allocation to highest bidders, were followed. In the event of oversubscription in

'tender offer' the share price became the 'striking price' at which demand equalled supply. In case of the 'combination method', 75% were sold by 'offer for sale' and 25% by 'tender offer'.

The procedures of pricing and disposal of state owned enterprises were severely criticised in the UK. Many suggested 'superior alternatives', and those were: (1) Market forces could have been used to a far greater extent in the scaling of prices. 'Tender offers' lead to much more accurate pricing than 'offers for sale' and an element of tendering could be employed even when an offer for sale was the chosen method. (2) It is manifestly sensible to sell portions of equity over time rather than all at once. Once the first tranche is sold, a well established market exists, and further tranches can be priced with some accuracy. (3) The expenses associated with sale could have been substantially reduced. (4) For wider share ownership and to cut out the financial middlemen, a simple alternative would have been to give to each adult member of the population and equal number of shares in massive companies. The effect on government finances, due to privatization,

was seen from two angles: (1) short-term impact, and (2) the effect on its real economic position in the longer term. A major short-term attraction for the government had been that sales proceeds reduced government's public sector borrowing requirement (PSBR). Mrs Thatcher's government always attached great importance to reducing the PSBR. The ultimate effect on PSBR and long-term financial position, due to underpricing and transactions cost etc were found to be unfavourable. Under the circumstances bond financing was thought to have clear advantage over equity financing.

An important objective of Mrs Thatcher's government had been to promote wider share ownership, and especially share ownership by employees of the companies, as part of the desire to extend 'property-owning democracy' in Britain, and became possible only through privatization.

For poverty-stricken, resource-poor Bangladesh an active capital is the solution for economic betterment of the people. The use of a sound and functioning capital market will better support wide ownership of capital, foster financial resources, and a more market driven economy.

The author is the former Chairman of the Investment Corporation of Bangladesh.

THE Atlantic island of Madeira, best known for its wine and tourism, is aiming to become the offshore gateway to Europe for Latin America and southern Africa.

It has all the classical ingredients to develop into a fiscal haven and, in the world of international finance, you could say that time is on its side. It is on the same latitude as Bermuda, but longitude puts the capital Funchal in the same time-zone as London and Lisbon — one hour behind Johannesburg and just three hours ahead of Rio de Janeiro.

A decade of laying the legal groundwork for its International Business Centre, divided into four sectors, is beginning to bear fruit. Already there has been investment and the establishment of manufacturing from the Far East.

Madeira, a sub-tropical island discovered by the Portuguese in 1419, occupies 314 square miles and its cosmopolitan population of 271,000 enjoys a Latin lifestyle blended with traditional English influence.

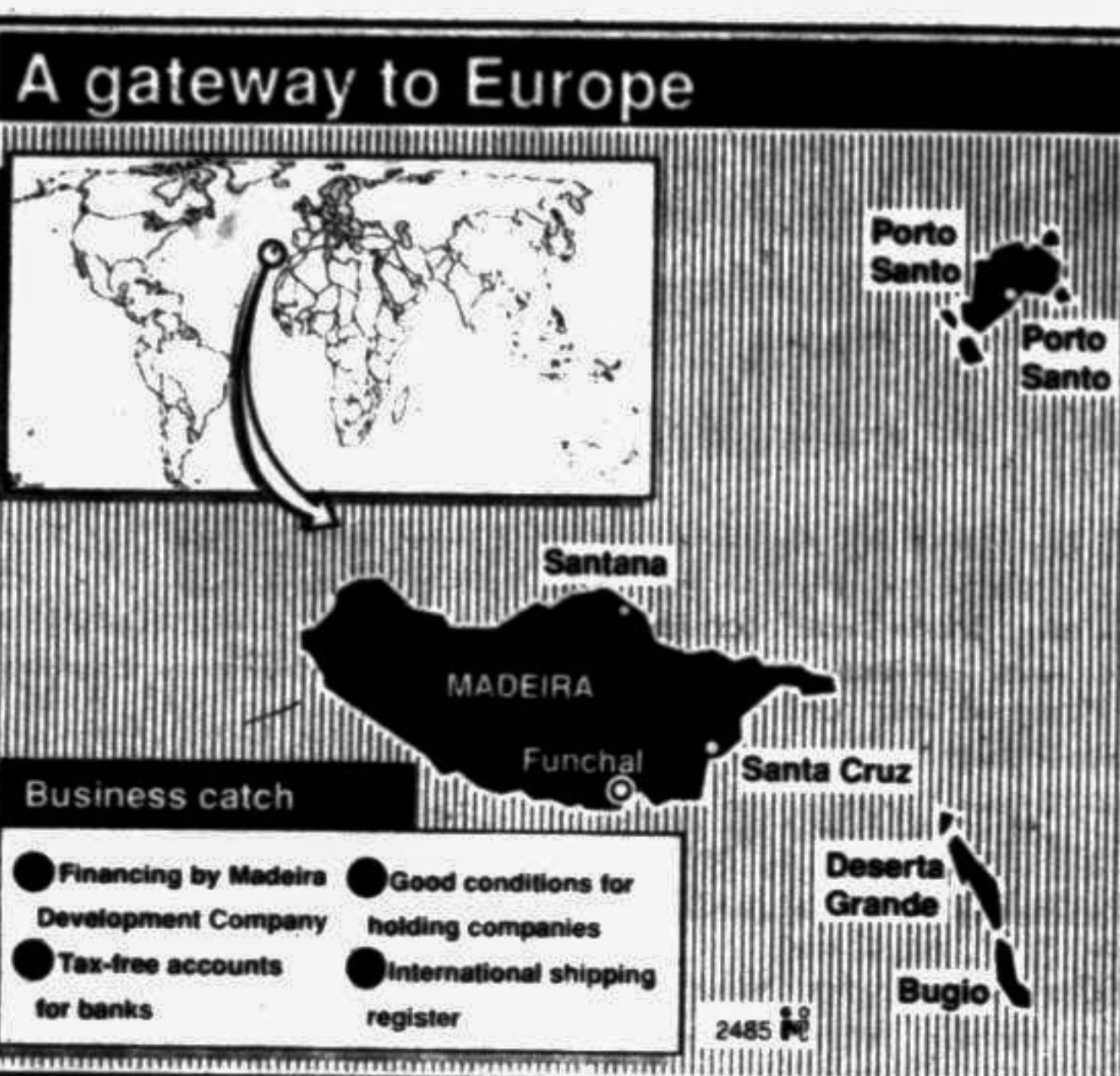
The even temperature of around 20 degrees centigrade has long attracted tourists, for whom a casino was specially designed. There is also talk of inter-continental routes through the enlarged airport at Funchal, which so far has flights from Lisbon, 600 miles to the north-east, and six other European cities.

Almost all the 361,000 tourists per year are from Europe, but the 4,000 expatriates living in Madeira come from other parts of the world. There are 2,700 Venezuelans, 170 Brazilians and 125 South Africans, as well as 61 from Panama. There are also nationals from Trinidad, Zimbabwe,

## Madeira Tax Haven Woos Developing Countries

The islanders of Madeira are among the poorest of Portuguese — which is why tourism and emigration have been their main routes of escape from poverty. Now, as Gemini News Service reports, the semi-independent island territory is becoming a tax haven with an eye on the South Atlantic basin.

— by John Burke



China and Iran among the 43 types of passport registered. Business from developing countries is also starting to come in, thanks to Madeira's flamboyant and ambitious governor, Dr Alberto Joao Jardim, whose right-wing Social Democrats aim to provide an image of stability. He has exploited not only

cent of the capital for the Madeira Development Company (MDC), which is registered in Luxembourg (but based in Funchal). Its offices are at Casino Park Hotel, run by a shareholder who once owned the largest building in Maputo, Mozambique.

Company deputy director Jose Antonio Camara says: 'We are getting enquiries from all over the world. We have sent a sales mission to Macau and we think assets will also be transferred here from Hong Kong. A double taxation agreement is likely with Japan, following one with Brazil, where we are doing a lot of negotiation. 'Finance will develop faster for Madeira than the industrial zone, even though a freeport will open in 1992.'

So far about 40 of the 120 hectares earmarked for untaxed manufacturing have been taken up. The dozen firms already there include a textile producer from Hong Kong, a Brazilian maker of plastics and two manufacturers from Lebanon.

Greater investment is involved in the second part of the International Business Centre. Twenty banks and one insurer have been licensed to open offshore branches in Funchal with tax-free accounts.

## Artists Keep Jamaicans Smiling Through the Gloom

JAMAICA is in deep economic trouble and only a few at the top of the tree — the directors and managers of companies and people in the professions — have managed to avoid a drop in living standards.

The most successful people these days are the entertainers and artists, not only by the way they touch the public but because of the money they generate.

The country has just celebrated 29 years of independence from its colonial status under Britain. To many there was little to celebrate, but where music is concerned, the trend has been just the opposite.

The late Bob Marley made reggae known throughout the world and made a fortune for himself. The annual 'Reggae Sunsplash' brings hundreds of thousands to Montego Bay, the tourist capital of Jamaica.

Artists are riding the boom in the art market. Jamaica has 24 art galleries and eight new ones have opened in the last two years. All stage regular exhibitions and provide a good living for the gallery owners and for 600 artists.

Towering above these is Barrington Watson, whose paintings sell at prices ten times higher than most others. His paintings have been bought by galleries in Canada, Panama and the United States.

In Jamaica, the main course of the Bank of Jamaica features his 10 by 20 foot painting entitled the Tea Party, depicting many well-known Jamaican personalities.

Watson made news early this year when, at his 60th birthday party, he announced plans to give his country residence and about seven acres of surrounding land to the nation, along with hundreds of his paintings, thousands of sketches and his collection of the work of his colleagues.

On the property will be built studio cottages for artists and a museum on a little knoll providing a view of the Blue Mountains and Kingston. Watson says it will be 'a place for artists, teachers of art and researchers to come and be at peace to create or think.'

The property alone is thought to be worth J\$5 million and the works of art, including some by Guyanese artist Aubrey Williams, bring the gift to many times that amount.

Watson's children have inherited his genius. His sons, Raymond and Basil, are successful sculptors. Last year they stage an exhibition of their work as 'Sculpture in the Park' at a small park in a Kingston suburb. His daughter has exhibited many paintings in Germany where she is now living.

## Privatization and Holding Company Operations-II

Khurshid Alam

greater support for tackling the large units and also the loss-makers at some point in the future.

It is understandable in this context that the holding company scheme is being implemented slowly now because of the imperative need to improve the financial position of the earmarked enterprise before market placements are made. One more pertinent point about the operations of the holding company scheme relates to the management structure of the related units. Though separate Boards of Directors, composed of nominated members of the Sector Corporation (holding 51 per cent of equity ownership) and elected ones from amongst the public shareholders exist for the related units, such Boards have only limited operational freedom in key areas of decision making.

For all practical purposes, the key decisions of the related units are made by the sector corporations and the Boards of Directors are merely 'ornamental show-pieces' of 'independent' corporate entities. This obviously runs counter to the basic purpose of privatization for improved management practices, dynamism and vigour through the participation of the representatives of the public shareholders in the Boards of

Directors. Even the service terms and conditions of the management personnel and other employees and workers are set forth by the sector corporations. This ensures the loyalty of the high-ups and others in the related units to the sector corporations, and not to the Boards of Directors which, under the Companies Act, should be entrusted with the responsibilities of running the enterprises/units in the corporate sector.

Besides the de-facto control of the sector corporations, the entire practice of giving a single government-controlled institution (Investment Corporation of Bangladesh) a larger weightage in electing the members to the Boards of Directors of the related units on the strength of its investment portfolio operations, on behalf of those maintaining in-

vestors' accounts with it, leads to virtual exclusion of private sector participation in a really independent manner in the management process.

The most pertinent aspect of the privatization programme under the holding company scheme in Bangladesh has been the ways the Board of Directors for the divested units are elected. Nationalized Commercial Banks (NCBs) of the government managed or government controlled insurance companies, and the ICB owning equity shares in the same, form a conglomerate and elect directors of their choice to the Boards of Directors of the divested units, out of the private shareholders quota in the same. In some cases, these government agencies together have retained a major portion of the equity offered for public subscription at the time of divestment of the same through the primary capital market.

And thus when the elections from amongst the ordinary public shareholders are held to the Boards of Directors of the related units, the ICB alone (on the strength of its shareholdings on account of its own portfolio operations and also on behalf of its individual investment account holdings) or the government controlled

banks and insurance companies or the coalition of the former with the latter enjoy a distinct advantage over the ordinary shareholders in their individual capacity, thus get-

ting their candidates elected to the same. This leads to the total non-representation of the individual shareholder in the Boards of Directors. Such shareholders, owning a relatively negligible proportion of the divested equity of the units under the holding company scheme, have indeed little scope to be represented in the Boards of Directors without the 'blessings' or 'support' of the ICB and the NCBs or government controlled insurance companies.

This is indeed the most severe operational flaw in the holding company scheme as it operates in Bangladesh. And in the process, the basic purpose of privatization for infusion of new management and dynamic practice for related units by way of private sector participation in the same is frustrated.

Privatization cannot be expected to unfold the possibilities for greater efficiency through market orientation of the divested units. In its present form, the privatization has thus meant little changes in management practice for the units. Immediately effective

steps, legal or otherwise, are needed to address this problem, so that the basic goals of privatization can be served in essence through divestment operations under the holding company scheme.

The retention of 51 per cent government control or that of the government owned public sector corporation over the equity of the divested units under the holding company scheme, is certainly another issue that deserves serious consideration. This practice has denied the real operational scope and opportunities to the divested units for their greater market orientation and efficient running with effective participation of the real private sector in the same. It has only served a window-dressing purpose, raising some money through 'public subscription' of equity capital up to 49 per cent of the related units (and that too with funds available from the government controlled bodies). But, the real objectives of privatization for opening the control of the related units are belied in the process.

This gives a discouraging picture about the operations of the enterprises or units under holding company in terms of the stated goals of privatization. As a sound political tech-

nique to transfer power out of the hands of the vested interests into the hands of individuals for recreating, in the process, the conditions for operations of a free market economy, the holding company scheme has thus not succeeded in creating yet any visible impact.

A successful privatization programme in terms of its stated goals and objectives will largely depend on a sustained public campaign to arouse public consciousness, particularly in the under-developed countries, about its imperatives and needs. Without such a campaign, the political goals and the socio-economic objectives of privatization as an active public policy action will be frustrated. And while the campaign is made, the objective conditions for the functioning of a market economy along its 'rules of the game' must be created.

Privatization has now taken a positive policy direction on the total economic planning of the country. In almost all countries of the world, it has taken firm roots in total economic scenario. It therefore needs to be planned and implemented in the context of the economic, social and political perspective of different countries. We can therefore very conveniently engage international organizations for a Master Plan of privatization in the country which may be amended and adjusted with the situation as may be required from time to time. (Concluded).

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