Central **Europe Economic Letter**

December 2002 economic trends • comparative analyses
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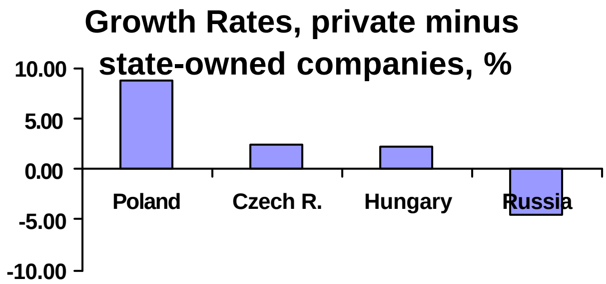

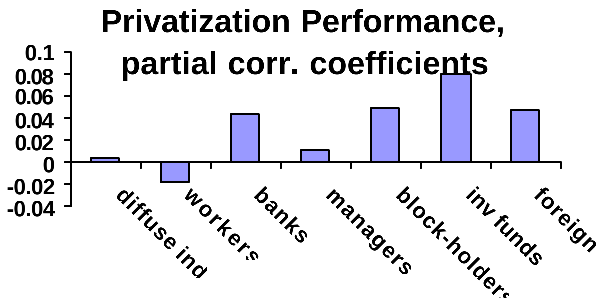

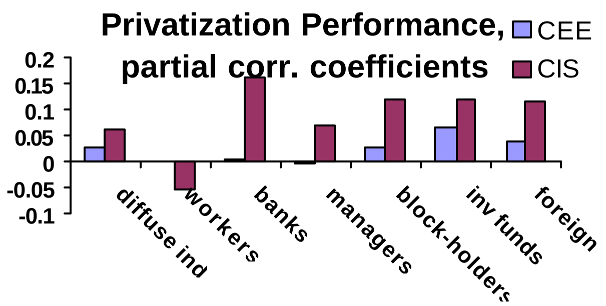

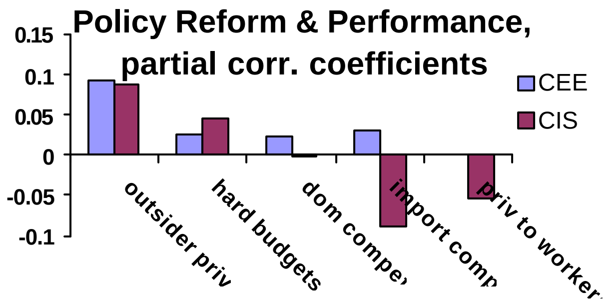

How Much of a Difference Does Privatization Make?

The conventional wisdom holds privatization for a paragon of efficiency. Panel studies spanning dozens of countries and decades worth of time series have generally confirmed this dictum. In this short note I look at two additional questions culled from composite results of third-party research: (i) what types of privatization methods delivered the biggest gains; (ii) how other policy reforms measured up compared to privatization.

Measured most broadly, there is strong evidence for the claim that 100% private companies grow faster than 100% state enterprises. The excess of growth rates of private firms over state-owned ones varied from 2% for the Czech R. and Hungary to over 8% for Poland (see graph 1). The anomaly of Russia is hard to explain, given that in many other CIS countries private firms also performed better than state-owned ones.

Top-line growth is an attractive composite measure but it can be deceiving. When we look at the channels of privatization, the evidence becomes more nuanced. Graph 2 summarizes the effect a given method of selloff has had on post-privatization efficiency. Most privatizations did deliver gains, but some turned out to be more productive than others. For example, sales to foreigners have proven to be about four times as productive as sales to managers. Diffuse individual ownership (e.g., public shareholding) delivered little while privatization to investment funds, block-holders and banks enhanced efficiency. Privatization to workers subtracted value on a net basis.

The benefits of private capital have proven to be much greater in the CIS than in CEE, regardless of ownership type (see graph 3). Perhaps the upshot is that the former Soviet Union has bestowed upon its successor states such a level of collectivized inefficiency that *any* transfer of capital to private hands guaranteed large improvement.

Finally, it is instructive to juxtapose privatization against other popular reform measures: enhancing competition, and imposing hard budget constraints (no bailouts, tax forgiveness or subsidies). The evidence is unequivocal (see graph 4): all of these measures bring benefits in CEE and some in CIS but outsider privatization tops them all.

The results state the obvious except in this one case: that dispersed ownership adds little to efficiency. While there is little left to privatize (Czech and Hungary), Poland still plans large flotations. But the really bad news could be this: if privatization IPOs are perceived to be bad investments, could *all* widely held stocks suffer from disrepute, too?

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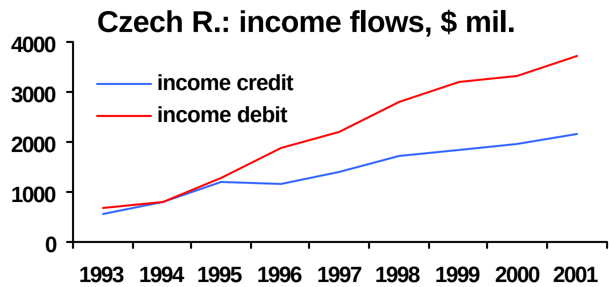
Financial Outflows Are Meager: Does It Matter?

The accession of the 10 candidate countries (EUCC) to join the EU – barring unforeseen circumstances – is now slated for May 2004. The common market in goods, capital, and labor will then stretch over almost the entire continent. When measuring the depth of integration, most of the attention from the vantage point of the EUCC has focused so far on trade, inbound foreign direct investment (FDI), and expected outbound flow of labor. But as assimilation across regions, markets, and sectors intensifies, capital and labor will flow more equitably in both directions.

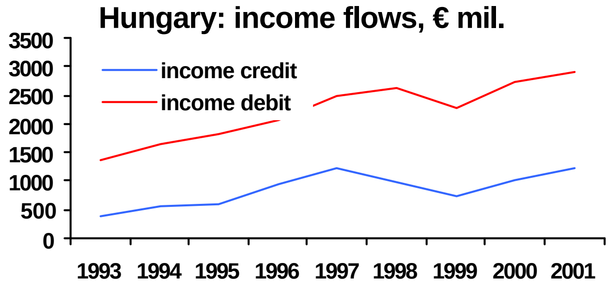
In this short note I look at the oft-neglected income flows (in both directions) and outbound flows of capital. The former are recorded on the current side, and the latter on the capital side of the balance of payments. Income credit (inflow) accrues to investments held by residents outside their domestic jurisdictions. Income debits (outflows) are earnings accruing to nonresident investments. Outbound flows of capital can be either direct investment abroad (DIA) – which are mirror equivalents to FDI – or portfolio investment abroad (PIA).

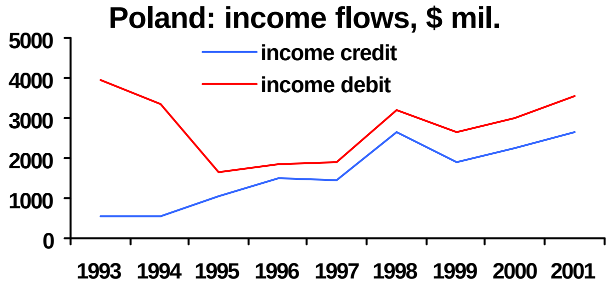
Income debits can be considered a function of the stock of invested capital, but also of relative profitability of (re)investment in a given country compared to other markets. Income credits and the flow of outbound investment are a function of many factors. Chief among them are relative expected profit rates, diversification of investments and resources, global strategy, and costs of doing business in various markets. EUCC are expected to step up their capital involvement in global markets at an increasing rate as they become richer, and when rates of return on domestic investments fall over time.

Data show that in the key three EUCC, income outflows always outweighed inflows (see graphs 1, 2, 3). This is not surprising given that emerging economies are generally net capital importers.



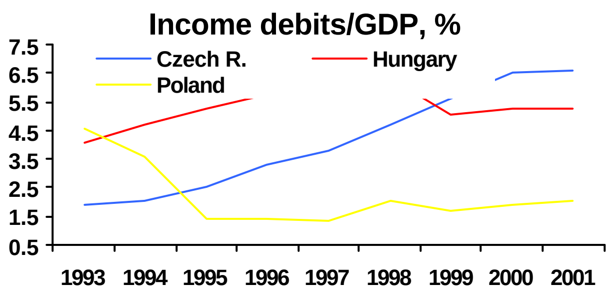
Second, outflows rose about three times faster in the Czech Republic than in Hungary, with Poland somewhat behind the latter (note: in HU the data are in euros compared to dollars in the CZ and PL). Even when adjusting for cumulative FDI, the Czech's annual income repatriation for 2001 was remarkably high. One explanation would be that rates of return (opportunity cost of reinvestment) are highest in Poland and lowest in the Czech Republic.



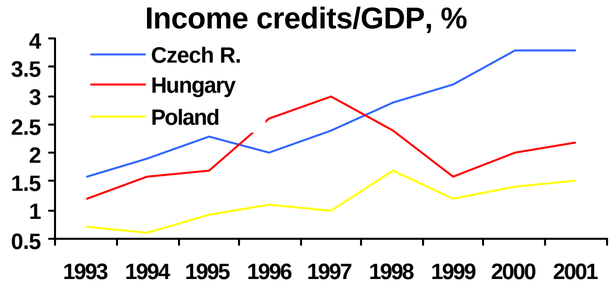


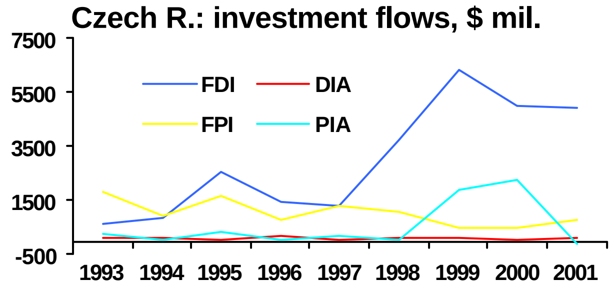
The third observation is that income credits (inflows) rose at comparable rates (adjusting for $/€ rate changes for Hungary's data). The simple explanation is that the bulk of this credit stems from central bank reserves' income. And FX reserves accumulation rose steadily in all three jurisdictions. By contrast, private portfolio money flowed out negligibly due to formal restrictions (except in the Czech R. – see graph).

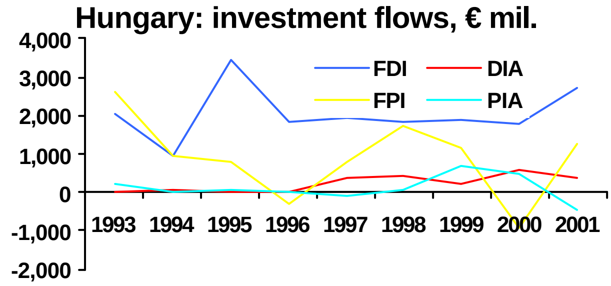
The negative income balance is not large: at about $1.5 bil. ($1 bil. in Poland) annually it does not present problems for the payments position in any of the countries. However, while the outflows are comparable in absolute terms, Poland records by far the smallest deficit in terms of the GDP (graphs below). Investment income outflows measured that way were surprisingly stable in Poland while rising in the two other economies. Again, the inferior stock of FDI in Poland compared to its peers combined with a higher relative reinvestment rate of profits appear to be the logical explanation.

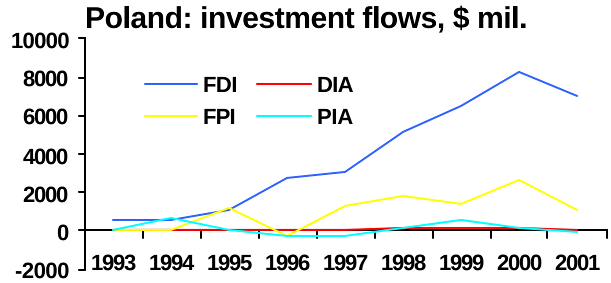


The analysis of capital flows starts with an overriding fact: FDI tops all other types of investment consistently. But the attention here is on outflows. And the startling observation is that DIA has barely developed over the entire decade (see graphs below).

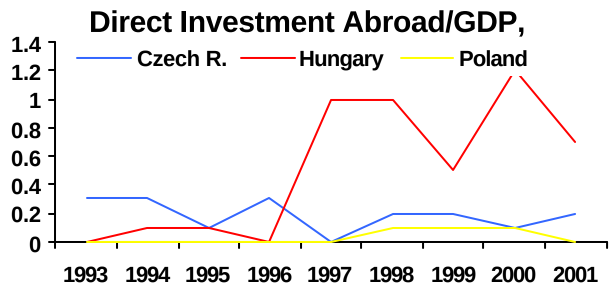




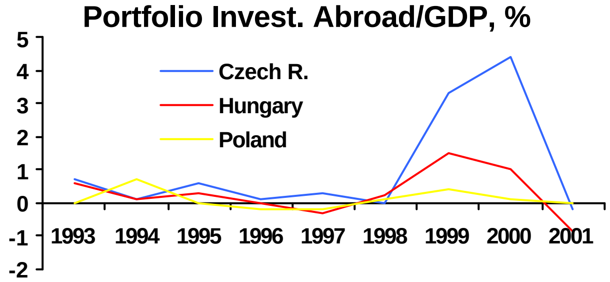




In Hungary, it's true, it rose a few hundred euros in each of the past five years (see graph above) but this hardly represents a solid record. The Hungarian DIA represented just 1% in terms of GDP (see graph below) and the figures for the Czech R. and Poland hovered in the 0.1%-0.2% range.



Portfolio investment abroad has been liberalized only recently in Poland and Hungary (the Czechs were free to do so since the mid-1990s). Yet even in that country PIA did not take off until 1999 when domestic interest rates fell sharply while the stock market failed to ride the wave of incipient economic expansion and the koruna strengthened steadily. The boom in outbound portfolio investment shot up to almost 5% of GDP – a spectacular performance in just two years – only to fizzle by 2001 (see graph below). On a net basis, all three economies have shown virtually no PIA last year.



The object of this short exercise was to discover trends (if any) in outbound flows of funds in the three EUCC. Of the three types of flows, current payments on foreign-invested capital in the form of interest and dividends showed the greatest stability. Both in absolute terms and in relation to GDP income debits rose. The negative balance on these payments is no cause for alarm as it is stable and insignificant in relation to GDP.

Outbound flows of capital have been small, both in absolute terms and in relation to GDP, over the entire decade. As a result, all countries have recorded strong capital surpluses which, more than sufficiently, financed current deficits. It is worthwhile to dwell on the corollaries.

The first one is obvious: these emerging economies attracted foreign capital because of superior earnings potential. On the other hand, domestic firms did not expand internationally probably for the same reason, that is, they preferred the relatively more favorable conditions at home.

This begs the second conclusion. It is probable that the region has not developed yet firms able or willing to diversify internationally. Either due to small size or risk aversion (high sunk costs, substantial learning curve), CEE companies are in no mood – after more than ten years of free enterprise – to set up shop abroad.

This need not be detrimental at this early stage of transition. However, the rising tide of globalization will intensify competition internationally. Central European firms will increasingly face counterparts from outside the EU operating in their jurisdictions. The earlier EUCC think globally, the better. And the respective governments ought to approach the export of capital with less mercantilist pontification and with more support and understanding.

What Strategy for Poland? Aim High But Start Modestly

The *National Development Plan 2004-2006* is a far-reaching document prioritizing Poland's economic strategy immediately following the EU accession. Prepared by the ministry of the economy, it is supposed to serve as a guidepost to direct structural funds into the most deserving sectors. Two of its numerous priorities caught my attention: (i) all regions and social groups should benefit from a level-playing field in development and modernization processes; (ii) the economy ought to generate a sharply higher share of income from high-value added sectors, including the high-tech. The latter point is worth examining. It says no less than that the government would like to alter the allocation of resources to turn Poland into a new tech center.

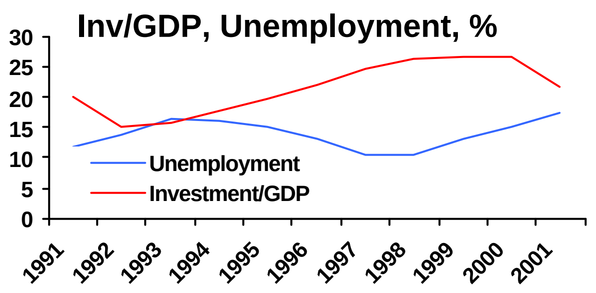
I believe that Poland would do better by channeling the money to satisfy more pressing needs. EU-assisted efforts to incubate new Silicone Valleys could result in less-than-efficient allocation of public funds.

It may be a noble intention to "move the economy up market", but in the case of Poland A.D. 2002-2006 this appears to me of secondary importance. Active policies aimed at permanently cutting joblessness rows should be promoted as first priority. That this objective is a natural choice is also confirmed by the existing mix of resources that Poland is endowed with. To illustrate better what I mean, it is instructive to start with basic economics.

Countries possess various quantities of capital and labor. The supply of capital is given by the domestic propensity to save and by net foreign inflows. Technology largely determines the quality of capital. The supply of labor is given by demographics and net immigration. Education and accumulated management culture largely determine the quality of labor. It is in the country's best interest to employ such a mix of factors which uses more heavily the factor that is more abundant. What should this be in the case of Poland?

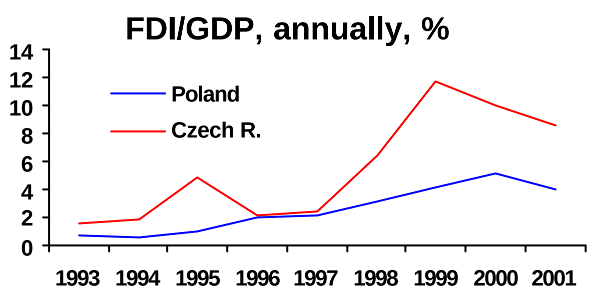
The domestic capital base has been relatively low because the funding sources have been growing slowly in absolute terms. As a result, the share of total investment in GDP has hovered at between 20% and 25% (see graph 1) compared to 35% in the Czech Republic. Foreign capital inflows have increased sharply and steadily over the past decade. Still, cumulative foreign investment per unit of GDP is the lowest among all EU candidates except the Baltics and Slovenia.

On the labor side, Poland boasts the highest number of households from among the EU-10 which earn no or negligible income per wage earner. It reflects hidden unemployment in the countryside, which is unique to the region. At the same time, the scholarization level of Poles is low – only 12% of population has a university degree (although the ratio of high-school to primary-school graduates is one of the highest in Europe).



The upshot is that Poland is poorly endowed with capital and well endowed with labor. There is no denying that increasing the capital-to-labor ratio is desirable. Higher capital intensity per man-hour contributes to productivity growth. In turn, higher value-added per unit of capital and man-hour (multifactor productivity) increases factor income, that is, profits and wages.

The snag is that "deepening" of capital occurs gradually over time as a result of learning, high investment, and relative prices of the two factors. In the case of Poland, with labor being abundant and relatively cheap, the opportunity cost of substituting for capital appears to be relatively high. Hence, in view of widespread unemployment, it may be socially desirable to promote labor-using rather than labor-saving technologies.



What does this mean? The logical strategy would be to promote investment in labor-intensive technologies which require low skills. Some services (tourism), low-tech manufacturing (foodstuffs, consumer goods or simple electronics) fit this pattern well. Low labor productivity would not translate into high wages, but the objective here is optimal employment of low-skilled workers.

The example of Southeast Asia over the past 40 years provides a pattern worth emulating. For those dreaming of an instant high-tech mecca, by contrast, history has a lesson: in the 50s and 60s the government's strategy promoted above all else the smokestack (steel, mining etc.). The opportunity cost of this misallocation of resources turned out to be rather high in today's zlotys.

Poland will do well if it spends EU funds on infrastructure, betterment of education, and cutting down corruption. Private investment will grow as a result – in all sectors – including those which devote growing funds to higher value-added generation.