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Liberalisation and Privatisation of Finance

Summary of the PRESOM work package on finance (from the second year report)

In the following contribution we will present the main findings of our analysis in a specific work package which was carried out during the second year of the PRESOM network. The objective of this work package was "to elaborate and clarify the multiple relationships between finance on the one hand and privatisation/liberalisation on the other hand". The conceptual basis for this work package was the understanding that the subject should be approached from two perspectives: In a more traditional perspective financial institutions – we limited the analysis to banks - are seen as targets for privatisation. The other perspective regards financial institutions as drivers of privatisations. At the autumn conference in Brussels in September 2006 a corresponding division of labour was decided.

1. Privatisation of banks

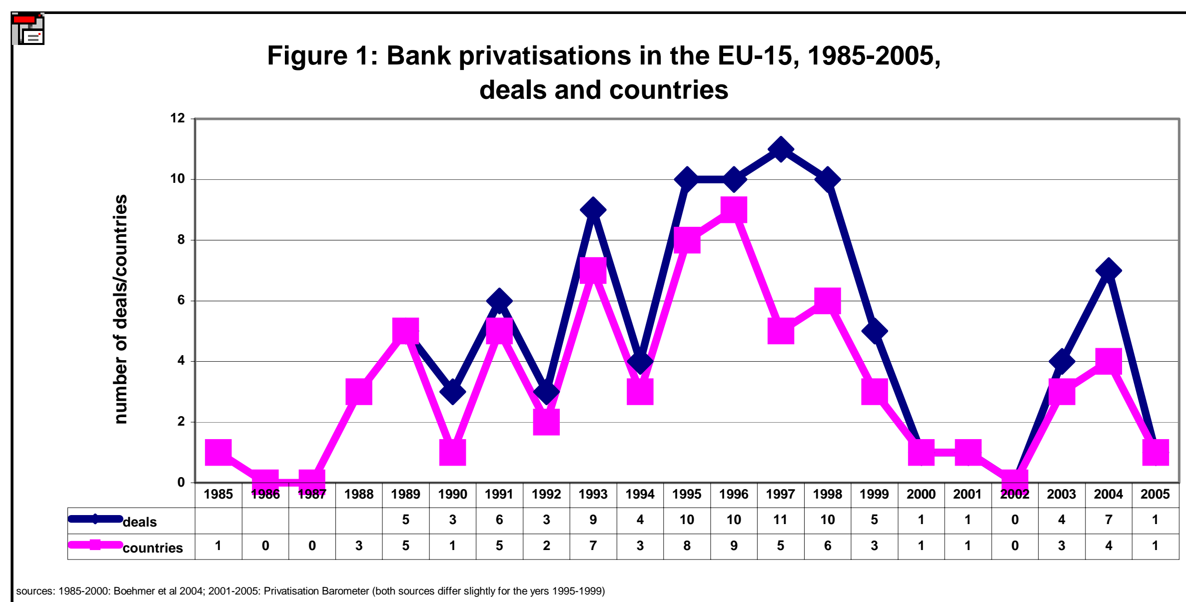
During the first three decades after world war 2 the economies of Western Europe were mixed economies with a substantial proportion of production, investment, and employment in the public sector. This applied also and particularly to the financial sector. In all major countries of the EU15 with the exception of the United Kingdom a relatively high proportion of banks and insurance companies were in public ownership. In France and Italy this proportion was higher than 70%, in Germany and Greece it was more than 40%. The main reasons for public bank ownership were the political ambition to control the "commanding heights" of economic development, to stimulate growth, ensure financial stability and to guarantee access to financial services for the weaker parts of the population.

1.1. Bank privatisation in the EU15

Bank privatisation in the "old" EU started in the second half of the 1980s and reached its peak at the end of the 1990s. It fell sharply after the New Economy Crash in 2000 and recovered only rather weakly in 2003 (figure 1). In an environment of emerging global financial markets public banks in EU member countries found themselves under increased economic, political and ideological pressure. The official rationales for this wave of privatisation were – like in other public services – mostly the belief that privatisation and competition in liberalised markets would enhance efficiency, and the increasing pressure on public budgets because of mounting social expenditure obligations in times of rising unemployment. Also the concep-

tions of creating a “peoples capitalism” and the desire to develop stronger national capital markets through privatisation played a role.

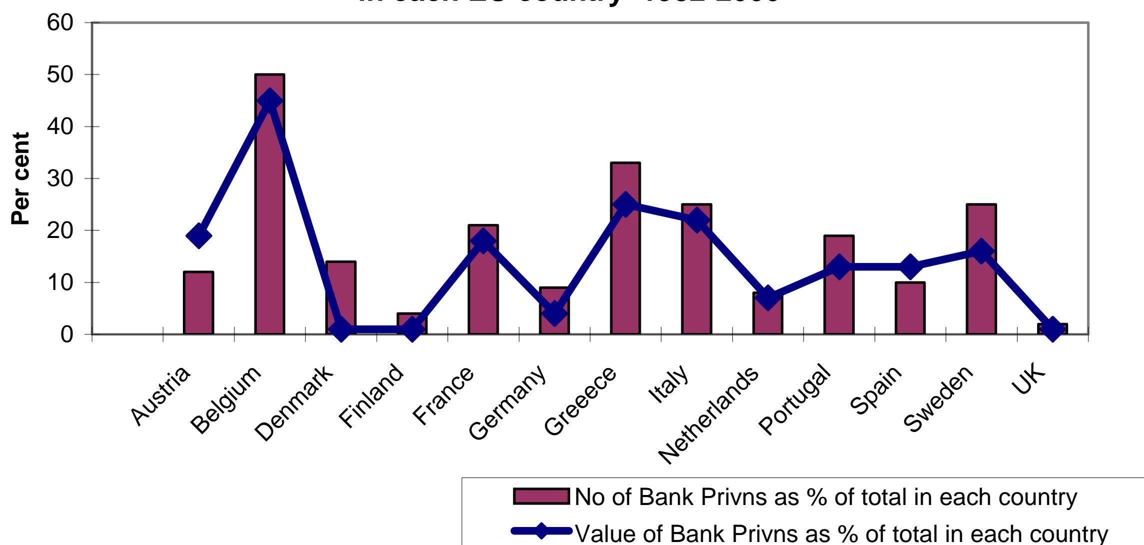
Figure 1: Bank privatisations in the EU-15, 1985-2005, deals and countries



	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
deals					5	3	6	3	9	4	10	10	11	10	5	1	1	0	4	7	1
countries	1	0	0	3	5	1	5	2	7	3	8	9	5	6	3	1	1	0	3	4	1

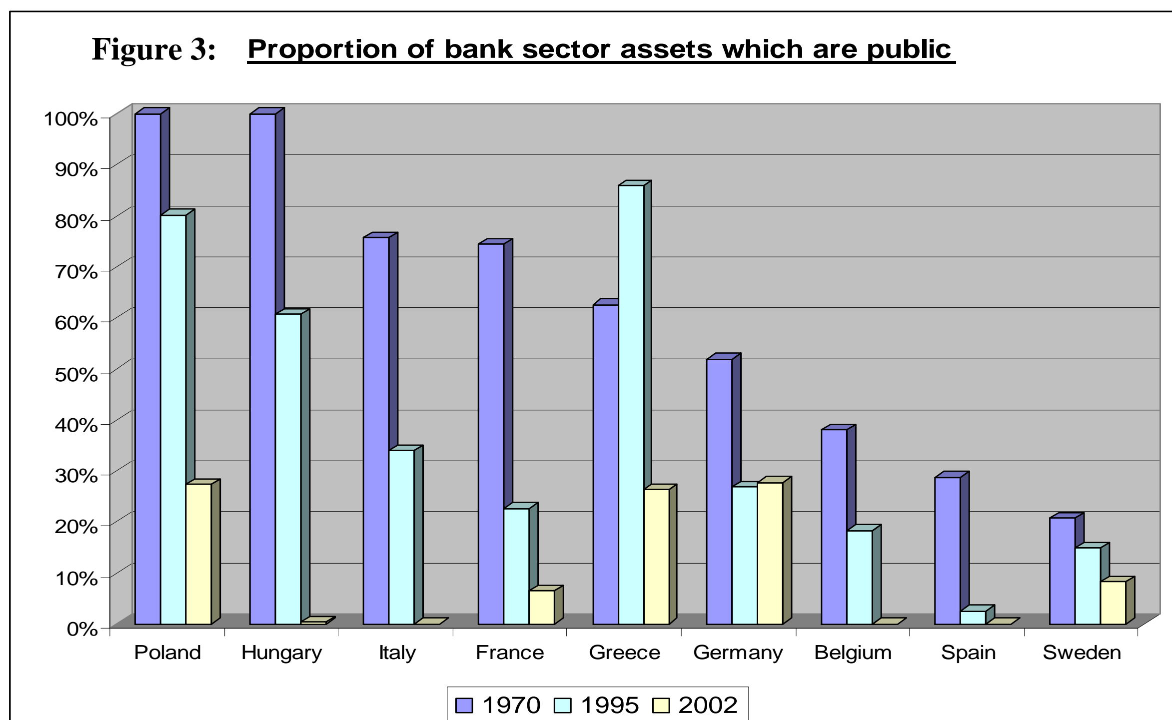
Within each country, bank privatisations accounted for a varying share of total privatisations, ranging from 2% in terms of number of deals and 1% in terms of value in the UK – where private banks prevail anyway – to nearly 50% in Belgium (see figure 2). Belgium is however an exception, insofar as the corresponding figures in the other EU countries are considerably lower. For example, Greece, a heavy bank privatiser during the period in question, recorded a 33% share in relation to the total number of privatisation transactions and 25% in relation to their value, followed by Italy, with a share of 25% and 22% respectively, as shown in figure 2. These differences imply that the impact of bank privatisations on the public budget, as well as on the spreading of equity ownership varied considerably across the EU countries.

Figure 2: Share of bank privatizations in total privatization activitiy in each EU country 1982-2000



The result of the wave of bank privatisations in Western European banking is impressive (see figure 3). In the large countries France and Italy the disappearance of public banking has been particularly drastic, while in smaller countries the fall has not been so steep. At present the country with the largest public banking sector of all EU27 is Germany with the strong savings bank sector which is mostly owned by the municipalities.

Figure 3: Proportion of bank sector assets which are public



1.2. Bank privatisation in the Central and Eastern European countries (CEEC)

In the CEEC financial liberalisation and privatisation was embedded in the comprehensive process of social rupture and transformation. For the financial sector the traditional monobank sector had to be broken up and a commercial bank sector was newly created. Lack of domestic resources and experience led to the result that bank privatisation in almost all new member states – with the exception of Slovenia – was at the same time a process of take-over through western foreign institutions. In the end amongst the larger banks in transition countries only OTC in Hungary and PKO BP in Poland remained in domestic hands, in addition to the key Slovenian banks NLB, NKBM, Abanka -Vipa).

Table 1 :Foreign ownership of productive assets in the NMS

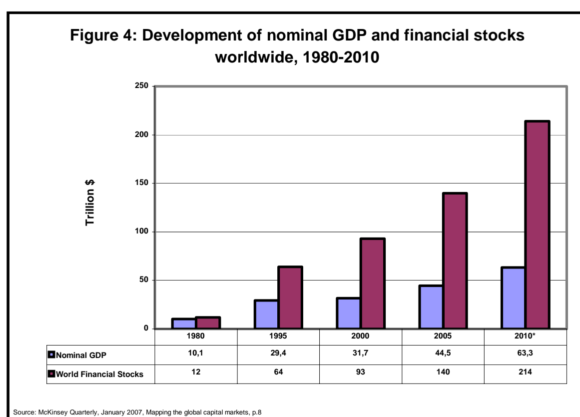
Country	1995	1999	2005
Czech Republic	22.8	48.4	84.3
Estonia	29.2	62.2	99.7
Latvia	27.7	69.8	58.9
Lithvania	16.0	45.3	91.0
Hungary	35.6	62.1	81.9
Poland	19.2	56.0	73.3
Slovenia	9.6	11.3	23.5
Slovakia	-	24.6	96.9

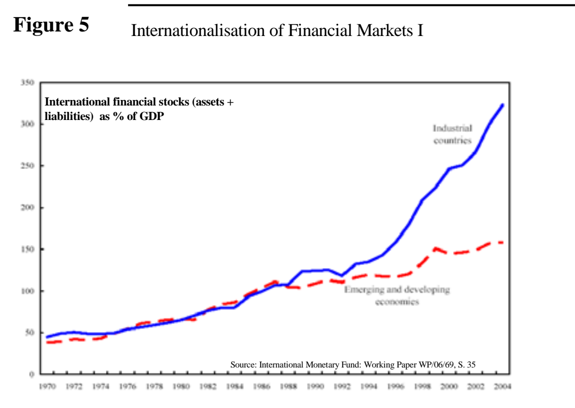
Source: UNCTAD 2004, World Investment Report 2004, UN New York; Havrylchyk, E. Jurzyk, E: LICOS, Leuven 2006; EBRD 2007.

As a result of the long process of privatisation in the financial sector we can observe three trends towards convergence. The first one is the trend towards a uniformly private bank system instead of the former mixed or completely public systems. The second one is the trend towards greater concentration through mergers and acquisitions. The third convergence is the trend towards stronger integration through cross-border take-overs, a trend which is much stronger in the CEEC but has also started to develop in EU15.

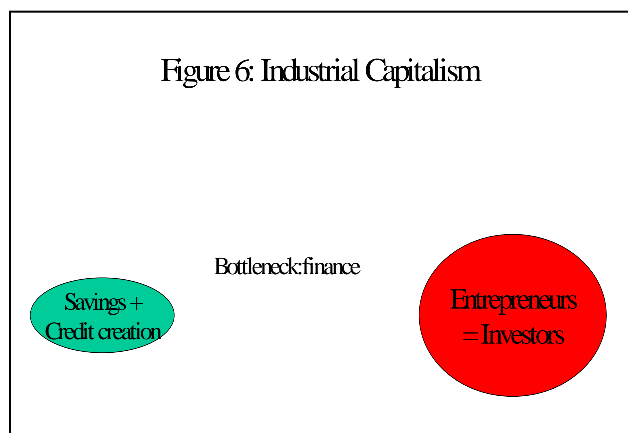
2. Finance as driver of privatisation

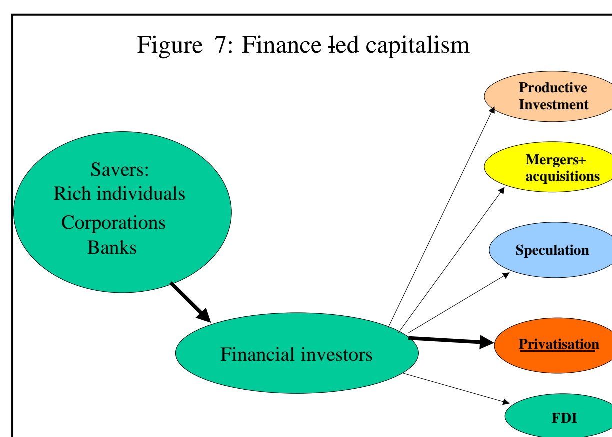
The analysis of finance as driver of privatisation starts from the observation that the accumulation and internationalisation of financial assets has grown very much stronger than world GDP and international trade over the last three decades. Between 1980 and 2005 world wide GDP grew from $10 to $45 trillions, world financial stocks increased from $12 to $140 trillions (see figure 4). In the early 1980s the amount of financial assets, which was invested internationally corresponded to about 75% of worldwide GDP; by 2004 this ratio had risen to 350% in the industrialized countries and to 150% in developing countries (see figure 5).





The general background for this development is, on the one hand, the long term redistribution of income and wealth from the bottom to the top, and, on the other hand, the recurrent "reforms" of pension systems, whereby traditional public PAYGO systems have been increasingly complemented and/or replaced by private capital funded systems. Under the pressure of increasing amounts of profit seeking financial assets and relatively fewer opportunities for profitable production the role of the traditional entrepreneur is increasingly replaced by the financial investor as the central figure in modern capitalism which becomes more and more a finance-led regime (see figure 7), as different from traditional industrial capitalism in which external finance is the bottleneck (see figure 6). Financial investors collect the financial assets from rich individuals, corporations and pension funds (who have collected the pension contributions from the employees) and invest them in a much broader range of activities than a single entrepreneur, manager or individual could do. Amongst these options privatisation plays an important role.





The shift towards finance-led capitalism has begun two decades ago in the 1980s and it is not yet terminated. It has in the first phase led to the set-up of very large ***institutional investors*** which absorb the masses of financial wealth and invest them, mostly in bonds and equities: investment funds, pension funds, and insurance companies. At the end of 2006 they managed altogether about $ 62 trillions. However, more recently banks and institutional investors have come under increasing pressure as a consequence of the acceleration in financial accumulation. Traditional institutional investors find it difficult to earn attractive returns for their ultimate money-owners. Under these circumstances a new generation of innovative financial investors or "***alternative investors***" emerges: Private equity firms open up new areas of investment (non-quoted firms) and hedge funds are developing shareholder activism in large quoted corporations. Both types of investors have in common that they claim and enforce higher levels of profitability in the firms in which they invest. Through the mechanism of competitive contagion these claims and the techniques to enforce them are proliferated throughout the economy – at the cost of employees and the quality of welfare systems. Financial investors have also been increasingly intensely involved in Public Private Partnerships (PPPs) in continental Europe, in Britain in the Private Finance Initiative (PFI).

The relevance of this shift towards a pattern of finance–led capitalism for privatisation is twofold:

Firstly, financial investors push for privatisation as an area of investment of private financial resources. In the framework of the emerging constellation of growing private financial assets seeking investment opportunities and growing pressures upon public finances privatisation appears as a solution to the problems of both the wealthy and the state: It gives the former a new area for investment and at the same time relaxes the financial burden for the latter. Governments sell assets and service packages which they cannot longer afford to keep and maintain because tax reduction for corporations and higher income brackets have diminished public revenue and the Stability and Growth Pact and corresponding national rules restrict severely public debts and deficits. But the same tax reductions have increased the net incomes of the beneficiaries at the top of the social pyramid. These use the additional money to buy from the government the assets and service packages. In a net calculation the whole procedure simply amounts to a gift to the top, or to a transformation from public to private wealth.

It remains an open question whether this privatisation of public services under fiscal pressures

fulfils it purpose to reduce the fiscal burden for the state. This is obviously the case when together with the privatisation public responsibility for the maintenance of the previously public service is abandoned – with the accepted consequence of a deterioration in the quality, affordability, accessibility etc. of such services. In cases where government privatises services but maintains their provision as a public mission (organised via public regulation or PPPs) the costs of regulation or of buying or leasing facilities and services from the private sector may be in a long-term perspective higher than higher public provision even if this must be financed through public loans.

In 2006 private equity activity in large European privatisations peaked: In six out of 59 large transactions with a total value of €40,4 billion private equity firms were on the buyers side, paying a total amount of €10,4 bn. i.e. 25% of all privatisation revenues (see table 2).

Table 2 : Private equity involvement in privatisations in 2006

Country	Company	% sold	Price €bn	buyer
Germany	Deutsche Telecom	4,5	2,68	Blackstone
	Woba Dresden	100	1,63	Fortress
	HSH Nordbank	24,1	1,27	Christopher Flowers
France	Pages Jaunes (France Télécom)	54,0	3,31	KKR
Netherlands	AVR Bedrijven (city of Rotterdam)	100	1,41	CVC Capital Partners
Total			10,3	

Source: privatisation barometer, Newsletters ns 5 and 6.

Secondly, under the pressure of shareholder activism for higher profits from the side of financial investors the traditional continental European stakeholder model in corporate governance is gradually replaced by the more aggressive shareholder model. Under these circumstances it becomes increasingly difficult to fulfil universal services obligations which have often accompanied the liberalization and privatisation process, on the European level (like telecommunications and postal services) and in the member states (gas, electricity et al.). The trade-off between higher profit claims and public service requirements becomes tighter, and to enforce the public service obligation requires tighter control and stronger measures. Both is expensive and increases the pressure on public budgets which privatisation was meant to relax.
Under these circumstances re-nationalisation or re-municipalisation of privatized sectors or firms appears as a new and better perspective not only for the level of public goods but also for the public budget.

Major Bank privatisation in Germany

While in the UK and the USA ailing private banks are subject of take-overs (Northern Rock) and take-over plans (Fannie Mae and Freddy Mac) by the state, in Germany things have al-

ready developed one step further. At the end of August 2008 the state-owned German development bank KfW sold its 90,8% stake of the German IKB – a bank with 1700 employees officially specialised in the finance of manufacturing – to the private equity investor Lone Star from Texas, USA. This sale ended 13 months of painful state attempts to rescue a bank which had extended its business activities beyond its traditional territorial limits and professional competence.

In the course of the latest worldwide financial boom, IKB had begun to speculate in the US sub-prime mortgage sector, and for this purpose had set up a special purpose vehicle or conduit named "Rhineland Funding Capital" based in Delaware, where there is almost no financial supervision. At that time the largest shareholder of IKB were KfW (38%), a "foundation for industrial research" (12%) and various private banks and institutional investors (together 50%). Via "Rhineland Fund" IKB speculated with loan packages for which it had no idea about the risks behind them – and during the first years made substantial profits for the public and private shareholders, who therefore did not intervene.

Things changed when the sub-prime crisis broke out. Although the management of IKB asserted in July 2007 that the bank were affected only in a low one-digit-*million* dollar range, it turned out within a few weeks, that the real losses which had to be written off amounted to about 10 b*illion* dollars – the highest single loss in the post-war German banking history – which the bank could not shoulder. Ironically it contributed to this amount the fact that Deutsche Bank, the largest private bank in Germany, succeeded to load off parts of its critical loan packages – and the corresponding losses – to IKB.

To prevent a collapse of IKB with potentially disastrous consequences for the German financial system the owners set up a rescue-package of 3,5 billion dollars in July 2007, 70% of which were borne by the state-owned KfW, most of the rest by the federal government. In November 2007 a second package of almost one billion dollars had to be provided, the share of KfW in the capital of IKB was increased to 45%, and in January 2008 it was decided to sell IKB. However, due to the prolonged financial crisis no buyer was found. A new injection of capital was needed. It was completely provided by KfW which thus became owner of 90,8% of IKB's capital. In the meantime the share price of IKB had fallen from over 30 dollar in the first half of 2007 to less than three dollar in August 2008. At last KfW got rid of IKB for a price of 137 million dollars – after the state had pumped about 11 billions of dollars into the bank. The financial situation of KfW has been severely damaged by the transfers and high public subsidies – taxpayers money - will be necessary to keep it afloat. And the story is not yet over: KfW has to guarantee the value of a substantial part of IKBs securities portfolio, which amounts to further incalculable risks for the state.

The future of IKB is open. Lone Star has a reputation for its rude methods in dealing with acquired assets and firms. It is known for its practice to squeeze out tenants in residential real estate and for cutting employment in the process of restructuring of firms. Although the German manager of Lone Stare has pointed out that dismissals were "not a priority" on his agenda for IKB, the perspectives for the employees are not bright.

Jörg Huffschmid

Railways: Privatisation in Germany, Re-nationalisation in New Zealand

The privatisation of the German railways corporation Deutsche Bahn, the last big infrastructure concern in public ownership, has been for many years subject of intense controversies in the country. The public debates generated a widely spread critical attitude and resulted in a

70% rejection of the privatisation plans on the side of conservative and liberal parties. Nevertheless the privatisation of Deutsche Bahn was foreseen in the agreement between the conservative and social democratic parties who form the German federal government since late 2005. In October 2007 it seemed that the project would end in a failure: A congress of the social democrats decided that any privatisation should include the issue of at least 25% of the shares as "peoples shares" to prevent a dominant influence of private investors on the German railway system (see NL 3 of November 2007). But in spring 2008 the proponents of a more outright privatisation within the social democratic party succeeded in removing this restrictive conditionality. They pushed through a model which foresees the split of the Deutsche Bahn into two separate corporations, one for the infrastructure (tracks, stations and services) and one for the transport and logistics activities. The first part (Deutsche Bahn) would remain in 100% public ownership – and would bear the largest part of the debts. The second part (named "DB mobility and Logistics") would include long distance, regional and local transport services and logistics, altogether about 90% of the business activities of Deutsche Bahn, and 24,9% of this part should be offered to private investors in an IPO later this year. The government expects a privatisation revenue of about 5 billion Euros – while it will continue to subsidise the Holding with more than 10 Billion Euros per year. Contrary to previous declarations this model can be implemented by simple parliamentary decision and does not require a privatisation law. The conservative coalition partner welcomed the model and declared openly that this would be the first step of a m ore comprehensice privatisation.

The week after the German government had decided its privatisation programme for Deutsche Bahn, on May 5, 2008, the ***New Zealand government*** decided to buy-back the country's railway system from the private owners for 665 million NZ$. New Zealand's railways had been privatised in 1993 for a price of 400 NZ$. In the years which followed the private investors had withdrawn high dividends from the corporation but made no investment for modernisation of the network and the services. Already in 2004 the government had therefore repurchased parts of the railway infrastructure. Now it takes over the whole transport services. New Zealands finance minister Michael Cullen declared at the occasion of the re-purchase decision that the selling of the country's rail system in the early 1990s and the running down of assets afterwards "has been a painful lesson for New Zealand". The government now plans to modernize the national rail system in a step toward building a sustainable transport network, which should reduce the emissions from the overall transport network and meet the challenges of global climate change.

For the German Deutsche Bahn the issue is not sustainability but international expansion and competitiveness. German customers will not benefit: In spite of record profits in 2007 and expected new record profits for 2008, Deutsche Bahn has announced an increase in ticket prices by 3,9% plus a service charge of 2,50 €if tickets are bought at the counter or via telephone. The company needs the profits and the privatisation proceeds not to improve the regional coverage, comfort and affordability of the German railway system but to support the ongoing worldwide expansion and to finance take-overs in France, the UK and Eastern Europe on its way to become a dominant global player.

Jörg Huffschmid