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TURKISH INDUSTRIALISTS'AND BUSINESSMEN'S ASSOCIATION

PRIVATIZATION IN MEXICO AND ARGENTINA

A BRIEFING NOTE PREPARED BY THE WHARTON EMERGING ECONOMIES PROGRAM

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I. EXECUTIVE SUMMARY

Mexico and Argentina have both recently initiated ambitious privatization programs. While both programs are considered highly successful, there are important differences and lessons to be learned from the experience of these two countries.

I.A The Mexican Experience

The Mexican experience represents a textbook example of a carefully designed and executed privatization program which started with small scale privatizations and, in a short time evolved into a full scale program with the successful privatization of larger and more complex companies with increasing frequency and public acceptance. The legal foundations of the program have been clear, and the procedures for asset sales were carefully established for maximum transparency and public acceptance. The importance of an adequate institutional capacity was well understood and resulted in the creation of a special agency.

The results of the Mexican privatization program have been impressive. By the end of 1991, the Mexican government had liquidated, merged, transferred, or sold 940 of the 1,155 state owned enterprises with a cumulative value of over $14 billion, about 6% of Mexico's GDP.

The Mexican privatization program began as a part of an IMF sponsored stabilization program in 1983 under President de la Madrid. Until 1988, only small enterprises were privatized by liquidation in order to reduce the budget deficit.

Privatization began to gain momentum after 1989 under the direction of President Salinas and has since reached a stage that is profoundly different from the period 1983-88. Privatization, known officially as the disengagement program, is considered a part of a new structural reform package which includes trade liberalization, rescheduling of external debt, and deregulation of domestic markets.

A newly created agency at the Ministry of Finance, the Privatization Unit, was responsible for the execution of the program. The Unit was staffed with highly trained professionals as opposed to career bureaucrats. The Unit was responsible for managing the privatization process and supervising the financial advisors, known as Agent Banks, who were in charge of the transactions. By delegating the responsibility of the transactions to the Agent Banks the Unit was able to concentrate on the crucial preparation phase which involves the restructuring of the enterprises, the design and publication of conditions of the sales, the pre-screening of potential buyers, and public relations work.

The Mexican privatization program has all the important elements of a successful program: the proper legal foundations of the process, the institutional capacity to execute the program, and the political will and determination to continue with the program.

The lessons from the Mexican privatization program are:

- A privatization program is more effectively managed if the authority is consolidated in a central unit close to the center of power in the government.
- Privatization requires a trial and error learning process. To avoid major failures that will have adverse affect on the public opinion, small enterprises have to be handled first, building up the experience and expertise required for the successful privatization of large, complex and high profile enterprises.
- Do not set targets dates for sales unless you are sure that you can actually meet them. This avoids adverse effects on company performance, employee's morale, and bad press.
- The rules and sequences of the divesture should be clearly specified, transparent, well publicized and irreversible. This minimizes the scope for bargaining between buyers and the government and reduces public skepticism of the process.
- All sales are final. Requirement of cash payment without deferred payment arrangements and the determination of the terms of the sales contract before the bidding avoids negotiations after sale.

- Debt-equity swaps give unfair advantage to buyers by transferring government subsidies to the buyer and blurring the real price at which the company is sold.
- Two stage sale procedure has proved appropriate for large enterprises. First screen potential investors according to their financial, managerial and technical qualifications. The second stage can then focus solely on price. This allows the sales price to be the only criterion of sale and guarantees a qualified buyer.
- Keep the public, employees and managers well informed about the process.
- Programs for economic stabilization, deregulation and structural reforms are essential for a successful privatization program. It is only in an environment of economic confidence that investors can evaluate a firm and are thus willing to invest at the right price.
- Privatization can be used as an effective way to raise substantial revenues for the government and thereby play an important role in the macro-stabilization of the economy.

I.B The Argentinean Experience

Argentina has pursued an extremely ambitious privatization program since 1989 with the goal of privatizing almost all of its 305 state owned enterprises.

In stark contrast to the Mexican privatization experience, the Argentinean privatization strategy, at its best, represents a crash program with all the advantages and the problems associated with speedy administrative programs. The basic premise of the program in Argentina appears to take advantage of the window of opportunity right after the election of President Menem by privatizing major enterprises as quickly as possible before the opposition is organized.

The privatization program to date has yielded about $5 billion cash and $11 billion in the reduction in foreign debt from debt equity swaps and it has been a major part of the Menem administrations economic restructuring and stabilization program.

The legal foundation for the privatization program was established in the Economic Emergency Law and the Public Sector Reform Law. These laws effectively empower the minister responsible for privatization, currently the economy minister, to declare any or all companies in the state sector "subject to privatization". The central government is thus given a free hand to modify the legal status of state entities, create new entities through spin-offs, mergers, or closings, and/or to deregulate sectors of the economy. Most importantly, the law enables the ministry to privatize enterprises without further approval of Congress, whose role is restricted to monitoring the process. Often, the process is carried out by presidential decrees which in some cases have taken precedence over the existing laws and thus have created legal complications.

While the decision to privatize rests with the Minister of Economy, the process itself is highly decentralized at the company level. There is no central privatization unit as in Mexico and each privatization is done on a case-by-case method under the supervision of an appointed trustee.

The lessons from the Argentinean experience are:

- Legal authority has to be centralized in order to reduce the political and bureaucratic obstacles to rapid privatization.
- In order to privatize large number of enterprises in a short period of time, the government usually refrains from restructuring the enterprises prior to sale and transfers the control of the enterprise to the private sector with the initial sale of an initial share of usually 30 to 51%. The remaining share is kept by the state and later publicly offered on international and domestic markets. Foregone sales revenue due to lower prices before restructuring an enterprises can be partly recovered by selling the shares in tranche later.
- Macro-stabilization and liberalization of the economy is fundamental to attract investment; in the case of Argentina, this was crucial for bringing back the capital that left the country during the high inflationary uncertain times.

- Debt to equity swaps have been used successfully and extensively to reduce the public sector debt.

However, the emphasis on speed in Argentina created serious problems for the program. These are:

- Shortcuts for quick results, particularly extensive use of presidential decrees over laws, led to legal complications and frequent confrontation between the executive branch and the legislative branch of the state.
- Lack of care for transparency has led to allegations of corruption, which necessitated a reshuffle of responsibilities among ministries in mid-process.
- Privatized enterprises were sold to four major groups in the country which concentrated high degree of economic power in these groups.
- In order to maximize the revenues from the public offerings of the state shares in the second stage of privatization, public officials made irresponsible statements about the value of companies offered to public to generate public interest. In the case of ENTEL, the telephone company, such irresponsible behavior initially created a speculative fervor and caused share prices to rise sharply, but eventual market crash led to major losses for many small investors.
- A rapid privatization strategy without an appropriate regulatory framework for privatized monopolies resulted in higher prices and lower quality services in telephone, airline, and transport sectors.
- Inadequate and nonuniform procedures for the sale led to difficulties and occasional embarrassments. On one case, Aerolinas Argentinas, the state had to take back a 28% share, after local minority investors were unable to inject fresh funds in to the loss-making airline.
- Lack of clear guidelines and procedures for sales may cause delays in future as

the government will be subject to the closer scrutiny an supervision of the parliament. There is further problem with the clash of presidential decrees and the existing laws which may raise problems about the legality of sales.

While the privatization program in Argentina started with an impressive speed, it remains to be seen whether such momentum can be maintained in future.

I.C The Implications

The experiences of Mexico and Argentina shows that privatization can be implemented under very different legal and institutional structures depending on the economic and political conditions and opportunities in a country.

A successful program requires clear legal foundations and organizational and institutional capacity for the execution of the program. Resistance to privatization is almost a universal phenomenon by labor, the management of state-owned enterprises, bureaucracies, and the ministers who use the enterprises as part of their political power base. All these groups have vested interests in the status quo and will do everything to delay if not stop the privatization. Each country should develop proper institutional structure and procedures to overcome these obstacles that are unique to that country. It is also important that privatization program is undertaken as part of structural reforms for the economy with a proper regulatory framework and market structure to create competitive environment.

Public suspicion can be overcome by creating strict and transparent procedures and by informing all interested parties. Public resistance can be best overcome by fair and successful results as has been exemplified in the case of Mexico. There will always be setbacks or problems at the outset of each program, but a successful track record will eventually bolster public support.

The most important element for a successful program is the will and determination of the political leadership. The results in Mexico or Argentina would not have been achieved without the determination of Presidents Salinas and Menem.

II. PRIVATIZATION IN MEXICO

The Mexican privatization program began in 1983 as part of a IMF-sponsored stabilization program. The Mexican state-owned sector grew rapidly during the 1970s, under the Presidencies of Echeverria and Lopez Portillo, and in 1982 this sector consisted of 1,155 enterprises producing 12.6 percent of GDP and accounted for 36 percent of investment. However, by the end of 1991 the number of state enterprises (SOEs) had been reduced to 215. Table 1 summarizes the progress of the privatization program, or, as it is officially referred to, the disengagement program:

TABLE 1: PROGRESS OF THE MEXICAN DISENGAGEMENT PROGRAM (1983 - 1991)

Year	Number of SOEs sold	Other Modes of Disengagement	Number of SOEs at end of year
1982			1,155
1983	4	77	1,074
1984	3	22	1,049
1985	32	76	941
1986	281	176	737
1987	21	99	617
1988	66	139	412
1989	37	0*	379
1990	90	9	280
1991	65	N.A.**	215**
Total	346	594	940 (total sold)

* Not meaningful. The number of sales exceeds the decline in SOEs, indicating a data incompatibility problem.
** Number of SOEs at the end of 1991 is derived by assuming that other disengagement (NA) was zero.

The Mexican privatization program occurred in two stages. The first stage, from 1983-1988 under President de la Madrid, was characterized by the divestment of large numbers of small enterprises, mostly by liquidation. The second stage, from 1989 to the present, under President Salinas has seen a large jump in the average size and price of enterprises privatized. Direct sales and public offerings are now the more usual mode of divesture. The fiscal results of the Mexican privatization program in terms of receipts and the average price of the enterprise sold are shown in Table 2.

TABLE 2: SALE REVENUES FROM PRIVATIZATION

	Number of Sales*		Total Receipts		Average
Year	**Nominal**	**True**	**In Million Pesos**	**In Million Dollars**	**$Price**
1983	4	2	4,847	---	---
1984	3	1	208	1.2	1.2
1985	32	10	29,180	113.5	11.4
1986	28	14	61,593	100.6	7.2
1987	21	16	229,379	167.9	10.5
1988	66	51	1,180,750	524.8	10.3
1989	37	25	1,798,549	730.8	29.2
1990	90	59	9,017,209	3,196.5	54.2
1991	65	37	32,656,544	10,813.4	292.3
Total	346	215	44,978,259	15,648.7	

*"Nominal" sales refers to the number of legally separate companies sold.
"True" sales refers to the number of different sales transactions.

II.A. The Economic Background of the Mexican Privatization Program

Following the discovery of major oil reserves in the Gulf of Mexico in the mid-1970s and the big oil price increase a few years later, government revenues in Mexico rose sharply. The Mexican government responded by vigorously expanding its role in the economy, increasing the number of parastatal companies and expanding the reach of its social programs. This ambitious development activity was financed not only by the expanding government revenues, but also by heavy international borrowing. The external debt of the country rose from $7 billion in 1974 to $78 million in 1981.

The large drop in oil prices in 1982 precipitated a crisis. Mexico was unable to meet its required payments on the external debt and, in the financial crisis that followed, the government nationalized the commercial banks[1] and established complete foreign exchange controls in September 1982. A process of capital flight began. GDP fell by 0.6 percent that year, prices rose by 99 percent and the government deficit reached 16.3 percent of GDP.

A program to stabilize the economy was put in place in 1983 under IMF sponsorship. The stabilization program contained several elements aimed at reducing the problem of the budget deficit: (i) reductions in government expenditures, consisting primarily of investment cuts and the moderation of wage increases; (ii) tax increases; (iii) divesture; and (iv) reforms (i.e., increases) in public sector prices. Severe austerity measures helped reduce the fiscal deficit to 8.5 percent of GDP, but the cost was a severe recession in which GDP fell by 4 percent.

The privatization program began as part of this austerity program. By 1985 the economy was showing signs of improvement, with GDP growing at about 3 percent and the inflation rate down to about 60 percent.

The economy was then subjected to two additional shocks. First, Mexico City was hit by a massive earthquake in September 1985, which is estimated to have caused damage of about $4 billion. Second, oil prices plunged once again in 1986 to levels less than half those in 1985. As a result, GDP fell from $177 billion in 1985 to $127 billion in 1986 and inflation took off

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[1] During the 1970's -- a period of relative deregulation of the banking sector -- the government had allowed the development of multiples, where the traditional commercial banks could begin engaging in a broad range of financial services and products. Almost immediately after the bank nationalization the government announced it would soon spin- off the non-banking parts of their financial groups, including brokerage and insurance services. These pieces were sold in May 1984, signalling the government's desire to keep the private sector as a player in the financial and capital markets. Reprivatization of the banks started in 1987 when President Madrid announced the sale of non-voting stock in the banks up to a maximum of 34% (although not all banks sold off that amount). Complete bank reprivatization was proposed in May 1990 (under presidency of Salinas) and legal reforms in June 1990 allowed not only privatization but also foreign participation, and reestablished full universal-style banking companies (with restrictions on ties between financial and industrial groups).

again, soaring to 106 percent in 1986 and further to 159 percent in 1987.

The government's response to these crises was to commence a complete transformation of the Mexican economy. Rather than trying to solve particular problems piecemeal, the government chose to address the structural problems faced by the economy by undertaking massive structural reform. The privatization program, which had previously concentrated on very small, and relatively insignificant firms, began to tackle large firms, eventually reaching some of the behemoths of the public sector, such as Telmex and the airlines Aeromexico and Mexicana. The disengagement program took place in the context of other massive structural reforms which began shaping the economic environment for investment. Sweeping trade liberalization transformed Mexico from a highly protected economy to one of the most open economies in the world. Mexico joined GATT and reduced tariffs to an average of 10 percent by the late 1980s. There was also liberalization and deregulation at home as market forces were unleashed in transport (excluding rail), steel, fertilizers, and so on. Agreement was also reached on the rescheduling of the external debt, the so-called "Brady Plan".

The response of the economy to this policy regime has been gratifying, and has been called the "Mexican economic miracle". Some indicators are offered in Table 3.

TABLE 3: KEY MACROECONOMIC INDICATORS

	1986	1987	1988	1989	1990	1991
Inflation[1]	105.7	159.2	51.7	19.7	29.9	19.9
Real GDP Growth	(3.8)	1.5	1.7	3.2	4.4	3.6
Primary Surplus[2]	2.2	5.0	6.4	8.3	7.9	6.0
Financial Deficit[3]	16.0	16.1	12.3	5.7	3.5	1.3
Transfers	4.5	4.3	4.1	4.1	3.8	2.5
Interest Rate[4]	80.9	94.6	67.6	44.6	37.1	28.8[5]

All 1991 numbers are estimates of the Centro de Analisis e Investigacion Economica (CAIE), using data through August or September

[1] December to December change in consumer prices

[2] Government revenues minus government expenditures, excluding interest payments, as a percentage of GDP.

[3] Interest payments minus the primary surplus, as a percentage of GDP.

[4] Average cost of funds, Banco de Mexico.

[5] As of June 30, 1991.

II.B. The "Disengagement" Program: Special Features

There are certain elements of the post 1988 divesture process in Mexico that merit highlighting.

The Proposal Mechanism

Although formally the sector ministry with the administrative responsibility for an enterprise "proposes" it for disengagement, the assumption now is that, in principle, all enterprises will be disengaged and that the sector ministry actually has to justify retaining it. This subtle change in underlying attitude is partly responsible for the successful privatization of a very large numbers of enterprises.

The Privatization Unit

In most cases, the administrative responsibility for an enterprise slated for sale is transferred to the privatization unit in the Ministry of Finance. This unit was newly created in 1988, and therefore none of its key officials had any strong vested interests in the status quo. Its director, known as the Coordinator General, is an economist who was a professor at the Instituto Technologico Autonomo de Mexico (ITAM), also the previous home of the Secretary of Finance. The privatization unit reports to the Secretary, and the Coordinator General has the rank of an Under-Secretary. The Coordinator General is assisted by six officials of Director-General rank, all highly trained, motivated, non-bureaucratic professionals. Their job is to **manage the specific sales, but they do so in a supervisory capacity, the details are delegated to Agent Banks.** Thus the divesture are carried out in a manner recalling arms-length market transactions. The idea is to use the expertise in business valuation, and mergers and acquisitions already present in commercial banks but to do so at arms-length so that competition among the banks for the Government's business assures good performance.[2] Delegating the details of the sales transaction allows the privatization unit to concentrate on the crucial phase before the actual bidding process.

The responsibilities of the Privatization Unit are:

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[2] The business is very desirable since the Government typically pays the Agent Bank a commission equal to one per cent of the final sale price.

to ensure that a regulatory environment is in place before the privatization of monopolies;

to decide whether restructuring of the enterprise is necessary prior to sale;

to design, publicize and possibly renegotiate the terms and conditions of the sale;

to pre-screen potential buyers according to their technical and financial capabilities;

and last but not least, to keep the public as well as managers and labor of the respective enterprises informed of the progress.

As in all privatization programs, four modes of disincorporation of state enterprises (SOEs) are used:

a) Sale to the private sector by various methods;

b) Liquidation, i.e., sale of the assets and dissolution of the enterprise;

c) Merger with other public sector enterprises; and

d) Transfer of ownership to regional or municipal authorities.

Agent Banks

As mentioned above, the actual management of each sale is undertaken by an Agent Bank, appointed and supervised by an official of the privatization unit. The Agent Bank performs several functions. The first important one is to prepare a prospectus for the sale. Bids are invited with bidders often pre-screened for financial viability and deposits required before the prospectus is released to them. A second crucial function is to perform a technical valuation of the company in order to arrive at a reservation price below which the enterprise would ostensibly not be sold. The reservation price is based on the Agent Bank's judgement after various valuation methods have been employed to estimate the value of the enterprise. Obviously the reservation price remains a closely guarded secret until after the sale and it may in fact, remain a secret even after that.

Selection Criteria for Buyers

The basic style of the sale is that of a sealed bid first-price auction. The bidders are pre-screened to make sure that they are acceptable in terms of their technical, managerial and financial capabilities. All bids are then received at the same time in a previously specified location in the presence of public notaries, representatives of the Finance and Comptroller Secretariats, and the media. The plans of the bidders for the company in terms of investment programs and policies towards labor are taken into account, but the primary criterion at this stage, after the pre-screening of the bidders, is the highest offered price. The relative clarity of the choice criterion is a further factor in assuring transparency and fairness in the sales process.

To avoid bargaining after the a bid is accepted, Government draws up the legal contract of sale <u>before</u> calling for bids and permits potential buyers to question, and even modify, aspects of the contract before bidding commences.

No Debt-Equity Swaps

Mexico has stopped using debt-equity swaps completely in privatization. Authorities felt that this policy gave an unfair advantage to buyers in transferring government subsidies to privileged investors, who then bought companies for less than they were worth. The use of debt instruments as method of payment also left lingering confusion over the real price of the company due to problems of valuing the external debt. This would counteract efforts to achieve transparency of sales procedures.

Labor Relations

An important feature of the Mexican privatization program has been the absence of any serious opposition from labor. The Mexican government has managed labor relations with a carrot and stick policy. Labor's interests have been protected throughout the program in three ways. First, by law the unions have a right of a first refusal at each sale. That is, once the bids are known, the union can acquire the company by matching the highest bid[3]. One key measure to prevent abuse of this labor protection is the prohibition of resale. This prevents an outside bidder making a deal with the union to buy the enterprise after the union has exercised its right, thereby obviating the need to bid in the first place.

The second form of labor protection has been the understanding with all buyers that worker layoffs are not to occur after the sale of an enterprise. This provision is not restricted to a certain period of time during which the work force must be maintained, but is a long term constraint. Thus, buyers are limited to restructuring plans which do not involve cuts in employment. Necessary increases in labor productivity must be achieved through growth strategies, the retraining of the existing work force, and increased mobility of workers within the company. It should be noted, however, that the problem of excess labor is addressed by restructuring undertaken before privatization. Whenever possible, agreements with workers of enterprises slated for privatization are negotiated prior to sale. These agreements have in some cases involved a reduction in the labor force, but they provide a well defined "post privatization" environment for employees as well as the new owners.

In the case of the Telephone Company TELMEX, for example, an agreement between the government and the workers' union was reached prior to privatization in 1989 in which the need for negotiation of 57 different labor contracts was replaced by a single contract to which would be negotiated once a year. The agreement also permitted the company more discretion in moving workers from one job to the other and made provisions for lay-offs. In exchange, the government awarded workers substantial wage increases and greatly increased the spending on worker retraining and skills development. The agreement, together with sale of 4.4% of the shares to the union, resulted in a remarkable increase in the workers' commitment to the company,

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[3] Many enterprises have been sold to their respective labor unions under this provision -- a total of 16 in the period of 1989-91 alone. They have included enterprises from various sectors: fishing, sugar, food products, fertilizers, mining and auto parts.

which is reflected in a jump in labor productivity (even before the sale). In 1991, the first year after divesture, labor productivity increased further, mainly due to a cost-cutting reorganization by the new private owners. There have been some layoffs as part of these reorganization efforts, but most layoffs have been achieved through attrition. An attempt is made to retrain workers to adapt to more modern, labor-saving technology, thereby obviating the need to hire more workers as the network expands. Still, the prohibition of further lay-offs probably has reduced the price buyers have been willing to pay for enterprises, and, in some cases, has worked strongly against sale.

Third, there have been instances where employees have been sold shares in the company in order to encourage their cooperation. For example, the Telmex union was sold 4.4 percent of the company for $325 million; the money for the purchase was loaned to the union by the government bank. At the market price 16 month after the privatization sale (on April 16, 1992), this shareholding was worth 1.37 billion. The gain works out to over $20,000 per worker. It is not surprising that workers have not opposed divesture in this case.

In addition to the protection labor has received, labor cooperation has probably been induced partly by the drastic decision by the Government to declare Aeromexico bankrupt. In 1988, in response to a labor strike, the government shut down the airline, fired the workforce of nearly 12,000 workers, and sold the assets. Aeromexico today has about 6,000 workers. The copper company Minera de Cananea suffered through a similar process. The credible threat of job losses may therefore be keeping labor quiescent as divesture proceeds.

Foreign Participation

As part of its policy of liberalizing and opening up the economy to international trade, the Mexican government liberalized rules for foreign ownership of Mexican companies. Minority ownership up to 49 percent was permissible and even majority (or full) ownership is now possible under certain circumstances. As a result, there has been some foreign participation in the privatization program, although this is less than one might expect when such massive capital flows are involved.

II.C. Lessons from the Mexican Experience

There are many lessons that can be drawn from the Mexican experience:

1. Consolidation of divesture activity in a central unit, close to the center of power, which then supervises management of the sales by qualified agent banks, can be an effective way of organizing sales.
2. A transparent, well defined process with clearly specified rules and sequences, can ensure orderly sales. The scope for negotiations between buyers and the government should be minimized.[4]
3. Public and thus political support of the privatization program is crucial. To gain and maintain public confidence the privatization unit has to build a track record of success. This can be achieved by starting with small projects, so that experience allows successful handling of high profile projects later on. To ensure that target dates are met, sales should be announced only when all preparatory work has been completed. The public should be kept well informed about the progress of the process.
4. Programs for economic stabilization, deregulation and structural change are essential for a successful privatization program. It is only in an environment of economic confidence that investors can evaluate a firm and are thus willing to jump in at the right price. For tradable goods, trade liberalization and deregulation are useful precursors to divesture. For non-tradable goods in non-competitive industries, regulatory mechanisms should be designed and implemented prior to divesture.
5. Labor's cooperation and acceptance can be assured through protection of jobs or

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[4] After adverse experiences with deferred payment arrangements the Mexican government now requires a significant down-payment at the signing of the sale agreement and limit installment payments to 180 days. Another sensible way to reduce scope for negotiation after sale is to have the sale contract fixed and publicized before the bidding process.

other ways for labor to participate in the gains from divesture.

6. For companies not viable as sales prospects, liquidation can and should be used as an alternative to reduce the fiscal impact.

7. Privatization can be used as an effective way to raise very substantial revenues for the government, and can thereby play an important role in the macro-stabilization of the economy.

8. Clearly the are conflicts between maximizing revenues and other goals of the divesture program such as the issues mentioned above. The Mexican program is an example of how this trade off can be evaluated: Assuring labor cooperation by prohibiting lay-offs after sale and requiring cash payment (as opposed to debt-equity swaps, or deferred payment) are examples of measures which lower the sale price, but increase transparency and fairness, thus assuring crucial public support of the program.

III. PRIVATIZATION IN ARGENTINA

After some futile attempts to privatize some state enterprises during the military government from 1976 - 1983, the first serious privatization efforts were made under the Presidency of Alfonsin. When Alfonsin took office in December 1983, the state held total or majority interests in 305 enterprises, which contributed about 6% of GDP per annum to Argentina's fiscal deficit of 15.5% of GDP. Between 1983 and 1988, the government made various attempts to reduce the fiscal drain from unprofitable state enterprises, but these efforts resulted in only 4 privatizations, and yielded revenues of less than $32 million in an economy with a GNP of US$ 70 billion.

When Carlos Saul Menem was elected President in 1989 privatization efforts sharply increased. He quickly established the legal foundations required to reduce bureaucratic and political obstacles to effective privatization measures. The Menem administration set the goal to privatize almost all state enterprises by the end of 1992, and estimated to gain sales receipts of $20 billion (in the form of cash and debt). Responsibility for the privatization of enterprises slated for sale lies was given to the respective sectoral ministry[5]. And the privatization process is monitored closely by the President and the Minister of Economics.

Unlike the Mexican case, the Argentine program began with the privatization of two giants of the state sector, namely the telecommunications company ENTEL and the airline Aerolinas Argentinas, as well as the introduction of a toll on the concession of highways. Initial public criticism led to a change in procedure after the first year of the program; now a regulatory framework is introduced prior to the privatization of public services, gas, electricity, ports, water and the sewage system. This regulatory framework, which deregulates each sector as much as possible in order to facilitate competition, must be approved by the Congress, and puts in place a regulatory agency to protect the interests of consumers regarding the quality of services, tariffs to be imposed, as well as matters of safety.

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[5] To provide appropriate incentives to those sectoral ministries, expected revenues from the sale of the enterprises under their responsibility were included in the budgetary process.

In most privatizations the government follows a two-tier strategy by initially offering shares of 30- 60% in those enterprises through bidding, with the winners taking control of these companies. The remaining shares are held by the government and will be floated on local and international markets at an unspecified later date. This very ambitious program has been a remarkable success. At the end of 1992, privatization was pretty much on schedule and completed privatization transactions had raised a total of about $5.5 billion in cash and over $9.5 billion (nominal value) in bought-back debt. To date most of the major state industries, including the airline (Aerolinas Argentinas), the telecommunications company (ENTEL), and the gas and electricity utilities, and the oil company YPF have been partially or totally sold off. Highways, railroads, two television stations, the Buenos Aires Zoo and water utilities have been made into concessions.

Table 4 summarizes the progress of the privatization program under President Menem.

TABLE 4: PROGRESS OF THE ARGENTINE PRIVATIZATION PROGRAM (1990-MARCH 1993)

Year	Number of SOEs sold	Other Modes of Privatization[1]	Revenues (in million US$) in cash	in debt papers
1990	6	40	790.5	6,740.2*
1991	2	35	1,892.5	12.0*
1992	25	42	2,658.9	41.8* 2,633.8**
1993 (Jan-March)	10	0	147.23	73.7**
Total	43	117	5,489.13	6,794.0* 2,707.5**

1) Other modes of privatization are concessions for utilities, services, and oil exploration, joint ventures, and sale of shares of privatized companies.
* Face value ** Cash equivalent

III.A. The Economic Background of the Argentinean Privatization Program

When Alfonsin took office in 1983, the Argentine economy had accumulated a foreign debt of $46 billion, was running a record fiscal deficit of 15.5% of GDP and was experiencing 400% inflation with negative GDP growth. After a series of weak and contradictory measures, and a continued deterioration of the economy, Alfonsin inaugurated the Austral plan in June 1985 (when inflation hit 1,123 %). The Austral Plan was based on classic IMF guidelines, i.e. a policy which pegged the newly introduced currency, the Austral, to the dollar, together with a wage and price freeze, a significant reduction in the public sector deficit and a commitment to finance the government deficit only with "genuine resources", not by printing money. Popular enthusiasm for the new measures was high, and the plan was initially quite successful. Inflation dropped from 30% per month to 3% per month, and the fiscal deficit declined to 6% of GDP in 1985 and further to 4.7% of GDP in 1986. But the freeze had the effect of accentuating a downturn of economic activity already underway when the plan was launched. Facing strong political demands for growth, the government lifted the price freeze in April 1986, introducing a system of "administered prices" instead. As the economy began to expand again (financed by a resurgence of capital inflows), inflationary pressures reasserted themselves. The improvement in fiscal discipline achieved in 1986 was lost in the run up to mid-term elections in 1987. After some experimentation with variants of the original plan, the economy resumed its declining path, with accelerating inflation, rapidly increasing external debt and negative GDP growth rates. By the end of Alfonsin's presidency, Argentina's total foreign debt amounted to $59 billion; almost all of the long term debt (accounting for $49.5 billion) was owed by the public sector.[6]

Carlos Menem took office in July 1989. On becoming president, Menem performed a dramatic U-turn, jettisoning campaign talk of large wage increases and other expansionist and redistributive policies for an emergency austerity program. Privatization, as a complement to

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[6] Main creditors were commercial banks (60%), official bodies (18%) and bondholders (18%) -- including holders of locally issued dollar denominated government bonds (BONEX).

economic liberalization and deregulation, was considered an indispensable part of the desperately needed structural reforms. In addition to the privatization measures described in more detail below, the new administration moved ahead with reforms aimed at reducing the public deficit and opening up the economy.[7]

In July 1989 the austral was floated. In December 1989, wage, price and exchange rate controls were eliminated and strict public spending limits were announced. At the end of 1989, inflation was running at 5000%. Another round of hyperinflation (10,735%) had erupted by February 1990, necessitating a new radical reform package unveiled in March 1990. It included increases of state-controlled prices of over 100%, the end of Central Bank financing of the government, unilateral rescheduling of the internal debt[8], tax increases, and a rationalization of state bureaucracy. These measures succeeded in stabilizing foreign exchange and inflation. The annual inflation rate since has declined continuously to a mere 18.5% in 1992[9]. In March 1991, the austral was declared fully convertible into dollars at a fixed rate of A10,000 to $1; this rate has since then been successfully defended. According to the Convertibility Plan, the local currency[10], must be fully backed by foreign reserves and gold at a fixed exchange rate; indexation was prohibited; contracts can be denominated and legally enforced in foreign currencies, and recent Central Bank

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[7] The initial Menem plan received the support of the IMF, which agreed a new stand-by loan for Argentina. However, failure to meet performance targets led to intermittent suspension of the stand-by facility.

[8] Savers had a proportion of their interest earning deposits confiscated, receiving payment in ten year government bonds instead. At the same time the Central Bank lowered the high reserve requirements in the banking system, and reduced the interest payable to the banks on funds immobilized in this fashion. The effect of these moves was to reduce sharply the cost of servicing the internal debt.

[9] However, highly volatile monthly inflation rates remain a major concern. Up to March 1991 surges in the inflation rate seemed to be triggered by news that the government continued to finance its deficit -- running at about 7-8% of GDP -- by money creation. With the implementation of the so-called "Convertibility Plan" by the new Minister of Economics Cavallo in March 1991, the old promise to refrain from inflationary deficit financing gained new credibility. Since then erratic moves in the inflation rate have been attributed to the influx of capital previously held outside of the official economy (estimated at $16 billion), which finances increases in demand.

[10] In 1992 the austral was renamed peso, with 10,000 australs equal to 1 peso, thus establishing a 1:1 parity between peso and dollar.

measures permit the creation of checking accounts in dollars and move towards a greater integration between the coexisting monetary systems in pesos and dollars.
The external assets of the Central Bank have increased from less than $3 billion in 1989 to more than $12 billion at the end of 1992.

III.B. The Privatization Program: Special Features

The following features of the Argentine privatization process merit highlighting.

Administrative (Re-)Organization And Legal Framework

Since the beginning of privatization efforts under Alfonsin, the political and administrative responsibility for the privatization of state enterprises has been reshuffled among -- partly newly created -- government units:

The first privatization-related move of the Alfonsin government was the formation of Commission 414. The commission was comprised of representatives from government banks and ministries. Placed under the jurisdiction of the secretary-general of the executive branch, the commission was far removed from public enterprises. This first stage of privatization effort targeted only companies that had become public enterprises when the state rescued them from bankruptcy.

Under Commission 414 however, progress lagged behind government goals, leading to the establishment of the Ministry of Growth and Promotion in July 1985, under the direction of Manuel Tanoira, a private business man. This ministry promoted private sector participation in areas which were traditionally reserved for the public sector, such as communications, transportation, and general infrastructure. These efforts met strong resistance from the state industries affected and the lack of support from other parts of the government led Tanoira to resign in January 1986, without having implemented any of the privatization projects he promoted.

Toward the end of 1986, another organization with responsibilities in the privatization effort came into being, the Directorio de Empresas Publicas(DEP), which was under the jurisdiction of the Ministry of Public Works. It was given the authority to set financial targets for enterprises and its explicit objective was to study the principle public enterprises and to suggest efficiency improvements or to recommend privatization. In early 1987, the thirteen largest state enterprises were placed under this newly created holding company. In February 1987 the Ministry of Growth and Promotion was phased out and the real decision-making center shifted to the Ministry of Public Works, which shared decision making with DEP and the Ministry of the Economy. Unfortunately these three agencies were in continual disagreement and thus unable to undertake any concerted privatization activities. To resolve the conflict, additional responsibilities were transferred to the Ministry of Public Works. By 1988 decisions about public enterprises and privatization were made jointly by the Public Works Ministry and the DEP, working in harmony. They made some progress, including signing letters of intent to privatize Aerolinas Argentinas and the telecommunications company ENTEL. However, with the resignation of Alfonsin in June 1989[11], the actual sale of these companies was left to the new government.

The main achievement of the new Menem administration was to realize, and act upon, the necessity of creating the legal and administrative infrastructure for effective privatization.

Two major reforms were approved during the first months of the new administration: the Economic Emergency Law and the Public Sector Reform Law. These two laws broaden the power of the executive office in efforts to expedite reform.

The **Economic Emergency Law** enables the executive branch to suspend subsidies and transfers that affect state-owned corporations. This process enforces equal treatment for domestic and foreign investors and creates conditions for a more efficient overall privatization process.

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[11] Alfonsin lost the elections in early 1989 to Menem. An outbreak of food riots and growing concern over the stability of the political system led to the agreement between Alfonsin and Menem that the handover of power should be brought forward from December 10 to July 8, 1989.

The **Public Sector Reform Law** (also called Ley Dromi) which passed in August 1989 is the cornerstone of privatization program and is considered a legal master piece of Public Works Minister Roberto Dromi. This reform declares a state of emergency for all public entities for one year, extendable for a second year, and suspends legal action against the state for two years. The law effectively empowers the president to modify the legal status of state entities and to create new entities through spin-offs, mergers closings, or transformation. The Economics Minister[12] can now declare any or all companies in the state sector "subject to privatization", with the central government given free hand either to privatize or to bring private capital into nationalized industries. The law also allows the central government to deregulate sectors of the economy, such as oil and telecommunications industries, which until then had been tightly controlled by the state. The real revolution of the Law is that it enables the president, through the Minister of Economics, to complete the process of privatization without further approval from the Congress. Congress will monitor all privatization through a special committee made up of six members of the Senate and six members of the Chamber of Deputies.

Decentralization of Privatization

The responsibility for the privatization of enterprises to be sold lies with the respective sectoral ministry. This ministry appoints a trustee, who runs the enterprise and, if necessary, undertakes restructuring until control is transferred to the private sector. The sectoral ministry is provided with an incentive to complete privatization at a high sales price by having expected revenues from sale included in its budget.

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[12] Originally, when the law was passed in 1989, these powers were centered in the Ministry of Public Works. After allegations of corruption surrounding the privatization program, the Ministry of Public Works was abolished in January 1991, in the course of a cabinet reshuffle. Roberto Dromi was appointed Ambassador to Spain. Responsibility for privatization was transferred to the Economy Minister, then Antonio Erman Gonzales. He was replaced by Domingo Cavallo, a Harvard-trained economist, on January 29, after an exchange rate crisis triggered by a sudden run on the austral.

The Two-Stage Strategy of Privatization

The Argentinean government set the goal of beginning privatization proceedings for almost all state enterprises within a time span of only three years (1990- end of 1992). However, the goal was not to completely dispose of state ownership by the end of 1992, but rather to transfer control of these enterprises to the private sector. In most cases this is achieved by selling a share (usually between 30% and 60%), which confers control to the buyer. The remaining shares are held by the state until a later, unspecified date, when they will be floated on local and international markets.

The government usually refrains from extensive restructuring of enterprises prior to privatization. While this makes it possible to maintain a high speed of privatization, it also lowers the sales price of the company. It is hoped that by selling the shares in tranches the government will be able to capture some of the (hoped for) appreciation in market value of companies after investment and efficiency-improving-restructuring has taken place under private management[13].

The Role of Debt-Equity Swaps

The Public Sector Reform Law allows a complete spectrum of different privatization procedures. Among these are debt-to-equity conversions, which have been used extensively in Argentina's privatizations: At the end of 1992, privatization yielded $5,455 in cash and $11 billion in bought-back debt (nominal value) -- a ratio of 1:2 in favor of debt conversion!

One of the problems faced by the Argentine privatizations was closely related to the foreign debt. Because most of the state enterprises to be privatized are foreign debt obligators, necessary waivers by foreign lenders have to be given before they can be privatized. Some banks have been reluctant to grant waivers. Argentina tried to get a blanket waiver to cover all privatizations,

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[13] This idea worked well in the case of the telecommunications company ENTEL; 70% of its shares were sold in July 1990 at an implicit share price of 9 cents. In December 1991, half of the 30 % of ENTEL shares kept by the government were sold by public auction and the price per share was 24 cents. Three months later, at the end of March 1992, the remaining 15% was sold (by bidding) at a price of 40 cents per share.

which was rejected. In the case of Aerolinas Argentinas, for example, it took joint pressure from the U.S. Government (Brady Plan), the World Bank/IMF and the Argentine government to convince the banks to grant the waiver. As creditors of these enterprises, commercial banks were heavily involved in the negotiations and contributed to having the bidding system for privatization of enterprises based largely on conversion of foreign debt.[14]

Selection Criteria for Buyers

All privatization must be made through a call for bids, public auctions, or sales made at the stock exchange[15]. In principle domestic and foreign investors are being treated symmetrically[16]. When making an award, the Executive Power must not only take into account the higher offered price, but also any other possible benefits to public or common interest. To qualify, the bidders were required to have experience and capabilities of running business. Privatization plans also include a provision that the new owner must maintain the level of employment during the first year.

Preference can be given to parties which already have a partial ownership of the entity being privatized. On the other hand, employers, suppliers and consumers can be included in the program (Program de Propiedad Participada). Soft financing can be made available to them through this program.

Labor Relations

Argentina is tackling the reform of labor laws only now, after privatization is almost completed. This approach is problematic because it creates significant uncertainty for the employees

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[14] The lenders that held a state enterprise debt were not always those who participated in privatizations.

[15] There are some exceptions: direct contracts can be entered into with employees, suppliers, or customers.

[16] An exception is the public utilities sector, where foreign ownership has been restricted to a maximum of 10%.

and potential buyers of the firms being privatized. However, the Menem government confronted the need to reduce redundant labor prior to privatization in many state enterprises. In most enterprises, reduction of the labor force was achieved through voluntary departure, induced by severance payments paid by the government or, in a few cases, with company resources and commercial bank loans. This permitted the new owners to receive the enterprise already rid of most of its excess employment. In addition, existing collective bargaining agreements became ineffective upon privatization. This allowed the new management to negotiate fresh labor agreements albeit still conforming to Argentina's generous labor laws and not eliminating all of the benefits enjoyed by labor previously. While there are no systematic restrictions on layoffs by the new private owner, the achievable cost-reduction of such a policy is small in the short run, since existing labor laws require extremely high severance payments to workers.

Starting from in 1990 from a base of 222,000 employees in 13 major enterprises, the accompanying process of restructuring prior to, or as part of, privatization will reduce employment to no more than 42,000 by the end of 1993[17]. Of this reduction some 66,000 will have been transferred to the new private firms, about 19,000 retired, and 95,000 separated voluntarily with severance payments. The total cost of the severance program is estimated to be about $690 million, thus averaging at about $7,200 per affected employee. The total reduction, including all enterprises, is projected to be almost 250,000, leaving no more than 60,000 public enterprise employees by the end of 1993.

Until recently, Argentina's privatization program has experienced little significant opposition from the unions. On the one hand, this can be explained by factors such as low wages in the public sector, dual employment, generous severance benefits, and age profiles of the workers and good employment opportunities in the expanding private sector. On the other hand, it is important

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[17] When the Argentine airline was privatized 2,300 of the original 10,000 employees were fired, and in case of the train company 27,000 workers lost their jobs. In the case of the oil company YPF (to be privatized in 1993), restructuring involves the reduction of employees to 12,000, from 50,000 in 1989.

to note that President Menem, a member of the labor based Justicialista (Peronist) Party, won the 1989 elections with strong union support. Menem was able to persuade most of the powerful General Confederation of Workers (CGT) labor federation, which was split in the process, to support his policies. Therefore, during the first three years of his term, the divided union was not able to seriously threaten Menem's policy, despite of their opposition to wage freezes and drastic layoffs which occurred in the process of privatization of state enterprises. On November 9, 1992 the CGT staged a successful general strike for the first time under the Peronist administration. The walk-out marked the reunification of the labor movement, which during the preceding two years had been too deeply divided to seriously resist the administration's reforms. Their main demands now are higher wages, participation in the privatization of the social security system and the changes in the now planned reforms of the labor and pension laws.

III.C. Lessons from the Argentine Experience

The lessons which can be learned from the Argentine experience are:

1. Legal authority has to be centralized in order to reduce political and bureaucratic obstacles to speedy privatization.
2. If restructuring of the enterprises is not undertaken prior to sale, foregone sales revenue (due to a lower sales price) can be partly recovered by selling shares in tranches.
3. Macro-stabilization and deregulation of the economy is fundamental to attract investment. In the Argentine case, this was crucial for bringing back funds which had been transferred outside the official economy during long periods of capital flight.
4. A disadvantage of following a high-speed privatization strategy has been that an

appropriate regulative framework for privatized monopolies has not been put in place prior to sale. The negative effects in terms of high prices and low services are now beginning to show in the airline, telephone and transportation sectors.

5. Shortcuts for quick results, particularly extensive use of presidential decrees over laws, led to legal complications and confrontations between the executive branch and the legislative branch of the state.

6. Debt-equity swaps have been employed successfully and extensively to reduce public sector debt.

7. A lack of transparency of the privatization process has led to allegations of corruption, which necessitated a reshuffle of responsibilities among ministries in mid-process.

8. Privatized enterprises were sold to four major groups in the country which concentrated a high degree of economic power in these groups.

9. Inadequate and non-uniform procedures for the sale led to difficulties and occasional embarrassment. In one case, Aerolinas Argentinas, the state had to take back a 28% share, after local minority investors were unable to inject fresh funds into the loss-making airline.

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