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A RESEARCH ON THE TOPIC:

**THE ROLE OF FINANCIAL INSTITUTIONS IN FINANCING
PRIVATIZATION PROCESS
(THE CASE MORE EMPHASIS ON CBE)**

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Abstract

This paper has intended to assess the role of financial institution in financing privatization process. The study further analysis existing documentary data and additional information through conducting interview to the concerned personnel and investigating the weakness of Ethiopian financial sectors and other limitations in the economy in the process of financing privatization. The paper also assesses other country experience and leads to learn better and minimize the effects of the indicated limitations. Data are collected analyzed from the privatization agency and from the national or Central Bank.

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TABLE OF CONTENTS:

	<u>Page</u>
Abstract -----	I
Acknowledgment -----	II
 CHAPTER 1	
INTRODUCTION -----	1
1.1 Background of the study -----	1
1.2 Statement of the problem -----	3
1.3. Objectives of the study -----	4
1.4 Methodology -----	5
 CHAPTER 2	
LITERACHER REVIEW -----	6
 CHAPTER 3	
PRIVATIZATION PROCESS IN EHTIOPIA -----	10
3.1 Approaches to privatization -----	10
3.2 Aims and Objectives of privatization in Ethiopia -----	14
 CHAPTER 4	
MAJOR CONSTRAINTS AND IMPACTS OF PRIVATZATION -----	16
4.1 Major pitfalls of privatization -----	19
4.1.1 Structure of liabilities and lending policies of Banks -----	19
4.1.2 Absence of a stock market -----	23
4.1.3 The problem of valuation -----	25
4.1.4 Track record of public enterprises performance -----	26
4.2 Impacts of privatization -----	28
 CHAPTER 5	
CONCULSION AND RECOMMENDATION -----	30
 Bibliography -----	33
Appendix -----	34

CHAPTER 1

INTRODUCTION

1. 1 Background of the study

Public enterprises have been important features of the Ethiopian economy for over two decades but their overall performance has not been satisfactory. Ethiopia, therefore, has embarked on a privatization program since 1994 as part of the ongoing policy reform to address these and other ills in the economy. The Ethiopian privatization agency (EPA) is moving ahead with the sell-off nearly all state-owned enterprises. Upto June 1999, the EPA has sold 175 firms, mostly small retail shops for a total of about 360 million US Dollar. And the EPA planned for privatizing about 123 medium and large-scale firms in the next three to four years with technical assistance from Germany.

The privatized public firms mainly consisted of the retail Trade Corporation, composed of small shops that deal in groceries, food, shoes and leather goods, construction materials automotive service, textiles, and stationary. In addition the government sold fourteen small hotels and restaurants, thirty-four printing offices and fifteen furniture stores. The most prominent privatization were the sales of the Lega Dembi Gold mine the saint George brewery, the national tobacco factory and a number of meat dairy and livestock farms. The total sum obtained from this privatization was 2.86 billion Birr (360 million US dollar).

Privatization would require the mobilization of relatively large amount of resources to effect their (privatization firms) transfer to the private sector. The industrial countries and the developing countries like Ethiopia are not equally endowed with factors likely to ensure the success of a privatization program. Many developing countries those with low per capital income lack some of the ingredients for success for privatization such as capital entrepreneurs, and competent managers.

In addition to the above problems the weak banking sector and the absence of a capital market in the country would make the privatization process an arduous task and is likely to severely handicap the speed with which divestment is affected.

Financial institutions are urban biased and lack largely in financing privatization process in the country. The granting of loans and credit by banks depends upon the size and quality of collateral, usually fixed assets in the form of buildings and lands which they could offer rather than the impact of the activities on productivity and economic growth which the loans or credit would finance. Now days, all banks and insurance were nationalized. The banks recognized on the basis of functional specialization and guidance of NBE.

After nationalization of private insurance companies the Ethiopian insurance corporation was established to develop, guide, coordinate and control insurance business in the country. Since then (after establishment of private insurance) the EIC has relative to the past expanding and strengthening its services and capability due to competition.

Upon establishment the CBE under proclamation no 184 of August 2, 1980 has the objectives of extending loans, credit and other banking facilities to any person for specific purpose, negotiate, under write with private persons. Although financial sectors in actual sense played a key role in mobilizing and directing resources to priority sector of the economy it is still faced with a number of factors (problems) which limits its efficiency and effectiveness. The problems include CBE (bank) (business firms like all firms strive to earn profit) are institutions that accept various types of deposits (saving, time and demand deposit) and use the funds primarily to grant loans with high charge when the borrowers repay the loans (the borrower paid the principal times interest is high charge over a specific persons). Banks are financial intermediaries (institution) that served as middlemen in the transfer of funds from saver to those who invest in real assets such as lands, equipment and factories. Financial institutions promote efficiency by gathering the surplus funds of million savers and making them available to investors in the real assets.

1.2 Statement of the problem

A look into the resource base the financial institutions reveals several issues if one considers it from the perspective of need for financing privatization of public enterprises. Nearly 94 percent of the saving mobilized by all the banks are constitutes demand and saving deposits payable at request to customers and short term maturing liabilities. The share of time deposits believed to match up with medium and long-term loans stand at 6 percent. The granting of loans by banks depends upon the size and quality of collateral, usually fixed assets in the form of buildings and lands it could be offered rather than the impact of the activities on productivity and economic growth which the loans or credits finance. Thus, financial institutions in actual sense played a key role in mobilizing and directing resources to priority sectors of the economy, it is still faced a number of problems which limits its efficiency and effectiveness. A marked absence of transparency and education (awareness creation) of the public in respect of privatization process is also mentioned as a problem.

Banks lending policy preference tend to increasingly be tilted towards large, corporate and established firms to the neglect, if not to the exclusion, of small firms, as the latter firms are generally believed to the high risk compared to the former group of firms. Loan context decision in the Ethiopia context and perhaps in similar other countries are generally security based. Borrowers must provide marketable and fully registered properties (assets), at least equivalent to the loan they requested.

1.3 Objective of the study

This research has attempted to assess and looking into the role of financial institutions in financing the privatization process-paying particular to the potentials and constraints of the banking sectors. It is attempted to briefly define and explains the rationale for privatization, reviews the various techniques of privatization based on the country experiences. The specific goals of the paper are looking into the constraints of the banking sectors from the perspective of financing privatization. Assessing the existence of securities market, in the menu of financing and to check how the speed of the process in divesting public enterprises in the country.

Finally, the paper investigate clear relationships between financial institutions and their impact on privatization process and further investigating government attitudes to privatization process and identifying methods of financing privatization are the target of the research.

1.4 Methodology

Source and methods of data collection

The data was collected from the existing documents and the information source is the Ethiopian privatization Agency (EPA) and central bank. The source of the data was possibly both primary data and secondary data at large. The primary data used typically is interview to the respective personnel from the two offices by developing questions. The interview was unstructured and structured too. By developing a forum discussing about social, political and economic significance of privatization in the country. Almost the secondary data was to be used for data collection and analysis purpose. All published and unpublished, public and private documents, forms, manuals, reports and records were to be used by checking their reliability, suitability and adequacy.

Methodology of data analysis

The procedures of data collection and analysis were after data was collected from the previously defined sites from Feb. fifteen to March ten. From the end of March to mid of May the collected data was processed, analyzed, interpreted and within fifteen days the final report was submitted and presentation with defense was conducted in the final five days of May.

In conducting the research different materials, and tools are used and some of them are stationers (pen, pencil, paper etc); printers, computer access to print the proposal and the final research of the paper and data collecting cost is also another requirements.

January
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CHAPTER 2

LITERATURE REVIEW

Country privatization programs shows that a number of modalities have been used in financing privatization, among which equity financing, debt financing, debt-equity swap and combination of these could be identified (Nankani,1998,Vuylstek,1998).

Equity financing is often designed as the full or partial sale of public enterprise shares to the public or to a predefined single purchaser or a group of purchasers.

Sale of shares to the general public is often called public offerings. There are advantages of public offerings for they permit widespread, ownership allow the mobilization of resources from the general investing public, and are normally characterized by openness and transparency. However, a highly dispersed share ownership does not allow holders to influence the future course of action of the business of the company. In this case, the sale of shares to a single investor or a group of investors appears to be a more preferred approach particularly if the privatized public enterprises are poor performers and requiring further investment and financial resources. (Gray,1996).

Sales of share may be confined to local investors as in the case of Nigeria or Open to foreign investors. Foreign investors can participate in privatization transactions through portfolio equity investments or foreign direct investments. Portfolio equity investment were mainly operated through the purchase of shares floated in the international security markets. Commonly used instruments were ADRS (American Depository Receipts) and GDRS (Global Depository Receipts) which were extensively used in the sale of large Latin American telecommunication companies, particularly in Chile and Argentina (Sader,1993).

During the 1988-92 period, a total of US\$ 62 billion privatization revenues was obtained by developing countries. Of this, foreign direct investments worth \$14.5 billion (23.4 percent) have been raised by selling small and medium sized enterprises while portfolio equity investment of US\$ 4 billion (8.5 Percent) has been recorded (sader,1993)

There are two major sources of debt financing of privatization.

Bank Financing: The express of privatizing countries demonstrate that the banking sector could speed up or inadvertently slow down the privatization process by providing or retarding financial assistance to the investors. Cognizant of this fact, most government that have embarked on privatization program have implemented measures that will enable or encourage bankers to provide financial assistance to purchasers such as rediscounting of loans used for privatization or purposes, providing tax incentives for banks making credit available for privatization endeavors, and establishment lines of credit specially designed for privatization. Evidence from other countries shows that in all forms of privatization (public offerings, private sale of shares or assets, management employee buy-out) the banking sector played a crucial role by making credit available to the potential buyers (Vuylsteke,1988)

Government financing: Some countries have devised a financing arrangement in such away that the government receives less capital than the total value agreed up on and accept payment terms thereafter. According to this agreement, the purchaser often makes a down payment, with the balance being paid on installment basis out of future income of the company. (Gray 1996) This approach was tried in Chile, Brazil, Canada, Estonia, Hungary and Poland (Vuyisteke,1998,Gra, 1996). It has been argued that many countries resort to government financed sales when the financial systems are not strong enough to absorb the sales. Public enterprises are not sufficiently attractive, and buyers do not have enough cash to immediately pay the total amount they agreed to pay. The deferred payment method was also applied in Zambia as a means of encouraging individual who want to purchase state owned enterprises but did not immediately have the requisite funds

(Fundanga and Andrew, 1997) This, however raises the problem of enforcing future repayments of debts owed to the government. A number of companies, whose privatization was financed through this method during 1974 and 1984 in Chile, were repossessed and nationalized by the Government because of the failure to pay back the loan.

Debt equity swaps were employed in a number of major debtor countries such as Argentina, Chile and the Philippines mainly to ease financing constraints by bringing foreign investors, including commercial banks in to privatization transactions and partly as debt -relief mechanisms. In a swap, the debt holder who wants to buy the enterprise exchanges debt worth attraction of its face value in the secondary market. for equity holdings(kikeri,et,a1,1994). A good part of Argentines telephone, ENTEL, for instance was sold off to foreign investors for approximately US\$ 1.3 billion, involving a debt equities swap of US\$ 5 billion face value. In effect, total asset worth 6.3 billion US\$ was sold at a discounted value of US\$ 1.3 billion. By using this mechanism, Argentina has managed to reduce external debt Obligations by about \$13 billion during the 1988-92 period (sader,1993) However, the applicability of this instrument is likely to be limited to countries with extensive commercial debt (i.e debt owed to commercial banks) and is less relevant to least developed countries whose external debt is largely from multilateral and bilateral sources.

Other Financing Techniques.

It is worth mentioning at this stage that the above classifications of financing techniques do not necessarily preclude the use of a combination of different financing techniques. Moreover, in order to bolster domestic purchase power as well as to enhance employee participation, some government, in addition to the financing techniques described earlier, devised other means by which employees or the public at large could acquire stake in the purchase of public enterprises. They provided employees a number of shares freely or at a discount. In some cases, one or two shares were freely offered for

each share purchased at the offer price. This later case has been used in the UK and Chile in the early 1980s (vuyisteke,1998).

Another option widely used in the Transition Economies that have adopted the "mass privatization program" is the use of vouchers. Vouchers are certificates convertible to shares of enterprises mainly through an auction and are meant to raise the purchasing power of the population (Alexandro wicz,1994). It gives ownership entitlement to the holder. Some countries (eg. Mogolia, Romania) distributed the vouchers freely to eligible citizens, while others (c.g Czech Republic, Russia) apted to give it at a price that barely covers costs of printing, distribution and publicity. At the initial stage, this has helped create awareness among the general public about the mechanics of market operations. It has also helped for management and employees mainly, and the general public to some extent to have the liquidity with which they was able to buy assets of enterprises. Vouchers were meant to address a number of issues in this countries including the question of fairness or equal access, shortage of domestic capital, stimulate the development of domestic market and overcome bureaucratic procedures in a privatization and the difficulty of placing of values on assets. Voucher privatization has been implemented in Czech Republic, Kazakhstan, Lithuania, Poland, Romania, Ukraine and Russia and managed to dispose off a large number of enterprises in a very short time period (Gray,1996). Those financing techniques mentioned above are financing techniques common in other countries. In Ethiopia they are found in their ideal and childhood level. In Ethiopia the common financing techniques are banks, government and foreign sources or foreign buyers.

CHAPTER 3

The privatization process in Ethiopia

3.1 Approaches to privatization

Privatization, in a broad sense of the word, may be defined as ways that are often interchangeably used but not exactly mean the same. It may mean denationalization (the transfer of productive asset ownership and control from the public to the private sector), deregulation (the introduction of competition and efficiency enhancing techniques) and privatization of management while retaining ownership (E.g management contracts and leases) (Bhattacharyay, 1996, Kikeri 1994; Kay, 1986). Viewed from this perspective, Privatization is part and parcel of a broader policy reform in the move towards market based economies. However, despite the fact that the concept is broad, privatization in this paper is meant the transfer of productive asset ownership and control from the public to the private sector.

Public enterprises can be transferred to the private sector via a number of privatization techniques including public offering of shares, private sale shares, sale of enterprise assets, and management/employee buy-out (Vuylsteke, 1998). The new investors or owners of the privatized enterprises could, therefore, be the public, domestic and foreign individuals /companies, and the privatized enterprises management and employees.

The Ethiopia privatization Agency (EPA) is in the process of computerizing its operation with a local area installation of an integrated computer networking which will help it to have an organized management information system. The sequence of steps that are undertaken by the EPA as part of privatization process to prepare an enterprise for sale through its ultimate divestiture, are detailed below.

Due Diligence: A due diligence is undertaken to identify all the key issue that may potentially impact on the smooth divestiture process.

The due diligence review will generally include detailed analysis of:

The regulatory, fiscal and tax regime issues prevailing in the sector.

- Legal issues including those related to contractual obligations, court cases, disputes, loan covenants, etc
- Financial, technical, operational, marketing, staffing and organization issue at the enterprise level.
- The due diligence review provides a basis to the Government for facilitating any decision making processes to overcome identified constraints in the privatization process to ensure a smooth, efficient and timely divestiture. It also forms a basis in defining and evaluating options on an appropriate privatization strategy.

Privatization strategy: This aspect of the privatization process is aimed at defining an optimal mode of divestiture that is feasible of implementation and meets the Government's privatization objectives. The preparation of privatization strategy will generally include a detailed analysis of:

- the privatization objectives of the Government
- The attitudes and preferences of potential domestic, regional and international investors who may wish to participate in the divestiture process.
- Government policies related to the sector.
- The overall operations of the PE (public enterprises)
- The different options available with regard to the mode of divestiture with the pros and cons for each option.
- Decisions that need to be made by the Government to implement a preferred option.

Asset Valuation: all fixed assets held by an enterprise are revalued in order that the financial statements reflect more realistic and market-based values. These fixed assets

may include properties, buildings, process plant and machinery, non-specialist equipment, vehicles, and office furniture and equipment.

The asset valuation exercise also facilitates a clearer understanding to the Government and potential investors of the nature, capacity, condition and value of assets being divested.

Financial Audit: The financial audit is undertaken in accordance with international accounting standards to provide a true and fair view of the state of financial position of the enterprise at a given point of time.

Financial Restructuring: The purpose of financial restructuring is to ensure that all problematic items currently in the audited financial statement are segregated from the other items. The restructuring measures may include debt rescheduling or write off, debtors write off, stock write-offs and creditor writeback to ensure that the financial position of each proposed new share company is sound and viable.

The net assets in the opening restructured balance sheet will reflect the amounts of the revalued fixed assets and the other assets and liabilities as per the audit report, after incorporating the proposed restructuring measures.

Business Valuation: The EPA derives a value range for each new share company to be derived based on internationally accepted methodologies, which will be used to inform and guide the Government and the EPA in any negotiations with potential investors. Usually a discounted future cash flow valuation is undertaken to value the core business of a company.

Information Memoranda- An information memoranda is a document that describes in detail all historical aspects of the company such as its principal activities, financial performance, markets, sales outlets, distributors, customers, competition, suppliers, production process, human resources, fixed assets, procurement process, etc. In

addition, it also provides information on Ethiopia, its economy and key fiscal, regulatory and tax policies that are prevalent.

The purpose of the information memoranda is to provide potential investors an initial base of information on the company as a whole and the environment in which it operated. Based on this knowledge, potential investors may wish to under take their own due diligence of the company to determine their level of interest in participating in the tender and sale process.

Tender Instructions: The tender instruction comprise a set of rules and procedures that govern the tender process, the criteria by which bids will be evaluated and description of what is offered for sale.

Advertise the Company- The EPA advertises the company for sale using the appropriate advertisement media to the target local, regional and international markets.

Bid Evaluation- After the tender closes, the bids are opened and evaluated by the technical committee comprising staff from the EPA, in accordance with the per-determined bid evaluation criteria that were circulated to potential bidders as apart of the tender documents. Bidders are ranked according to the scores they got in the bid evaluation.

Commencement of Negotiations:- The Board of management of the EPA approves the over all frame work and strategy for the negotiations with the top ranked bidders.

Sign sales Agreement and other Transaction Document- sales agreements and related transaction documents are prepared and signed on the basis of mutual agreements reached during the negations process by all parties to the transaction. The Government receives the purchase consideration for the sale of company and the shares in the company are transferred to the new owners.

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3.2 Aims and Objectives Of Privatization In Ethiopia.

There are a number of objectives designed to be achieved by pursuing the policy of privatization of public assets. Chief among them are the improvement of the performance of both allocation and productive efficiency of resources via improving the performance of public enterprises, and reducing the role of the government to strategically and socially essential activities such as provision of basic infrastructure facilities. Privatization could as well be used to mobilize external resources and by doing so promote investments and foregone exchange earnings. Privatization can also help lighten the budgetary burden of public enterprise both by reducing subsidies, and improving government revenue from expanded operations of the privatized companies (Foundanga and Andrew, 1997; Bahattacharyay, 1996). Privatization is used to generate revenue required for financing development activities under taken by the Government. To change the role and participation of the Government in the economy, to enable to exert more effort on activities requiring its attention, and to promote the country's economic development through encouraging the expansion of the private sector. More than 3.5 billion income gained from the sale of public enterprises had been received up to now. Out of the 200 enterprises that were sold, more than 80% were shops and the remaining were factories and industries, and the highest sale was Legedenbi Gold Mining which was sold for USD 172 million. The money received from the sale of the enterprises is deposited in the National Bank as the Government's budget and is used for developing infrastructure from which the public could benefit. Privatization may also be pursued as part of the motive to build investor's confidence and encourage private sector development. The achievement of these, however, critically depends on the successful process of privatization of public enterprises, and the performance of the privatized companies.

As firms move from public to private ownership, their profitability increase. In response to shareholders wish to maximize profits, the managers of newly privatized firms can be expected to place greater emphasis on profit goals (higher profit).

The greater emphasis on profit and the cuts in government subsidies following privatization can be expected to lead firms to use their human, financial, and technological resources more efficiently. Governments expect that greater emphasis on efficiency will lead newly privatized firms to increase their capital investment spending. Privatized firms can also be expected to increase their capital expenditures because they have greater access to private debt and equity markets (especially in fairly developed capital markets) and more incentives to invest more investment. Correctly conceived and implemented, privatization can be expected to foster efficiency and investments and thus stimulated new growth and employment (higher out put). Most state enterprises tend to be overstaffed. So newly privatized firms could be expected to cut employment following government divestiture and the reduction of subsidies in order to increase efficiency.

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CHAPTER 4

MAJOR CONSTRAINTS AND IMPACTS OF PRIVATIZATION

The availability of financial resources that can be mobilized to finance privatization is a key element for the successful divestment of public enterprises. The experience of both developed and the developing countries amply show this fact. Financial sectors, mainly the banking sectors in particular play substantial roles in financing privatization in many developing countries. The banking system in particular would play a notable role in countries where the stock market is missing, or generate little resources. Naturally and owing to the absence of the capital market in Ethiopia, banks would be the only possible domestic sources of finance next to own fund in financing the privatization process.

Three sources have been used in the financing of privatization in Ethiopia, in addition to own sources of finance of the new owners. One is borrowing from the banking sectors by the buyer. Second is financing privatization from government loan. And thirdly financing from foreign sources, i.e foreign investment by buying the public enterprises.

Table 1

Privatization Financing by Source of Finance 1998-2002

Sources	Number of Enterprises		Amount of Financing	
	Number	%	Amount ('000Birr)	(%)
Banks	34	17	281,083	8
Government	54	27	137,446	4
Others*	112	56	3,100,000	88
Total	200	100	3,518,529	100

* This includes foreign and domestic financing other than the commercial Banks and treasury.

Source: Ethiopia Privatization Agency, and Commercial Bank of Ethiopia

Government Loan

This is mainly in the merchandise sector where employee buyout was financed from the treasury of the government at a subsidized interest rate. In other words, employees were organized and formed the Addis Fana General Merchandise and Hotels share company. They bought 44 retail shops and hotels worth 42.4 million Birr. This is a medium term loan payable within five years at six months installment. The total loan amounts to about 4 percent of the total privatization proceeds over the 1998-2002 period and a 4 percent interest rate has been charged on it. And, regular monitoring responsibility is given to the Development Bank of Ethiopia so as to ensure that the money is paid back as per the agreement of the employees with the government.

Foreign Resources

Of the 3.5 billion Birr privatization proceeds about 3.1 billion Birr was obtained in the form of US dollar, mainly from the sale of legedembi gold mining enterprise to the National Mining corporation which is mainly foreign based company. This constitutes about 88 percent of the total proceeds generated so far from privatized public enterprise. Thus, this indicates that public can be sold to foreign investors.

Domestic Bank Borrowing

Bank borrowing is the other source of financing privatization, particularly in countries banks are the only means of borrowing money. So far, about 281 million birr has been paid from the banking system to partially finance the sale of 34 companies. This constitutes about 7.3 percent of the total proceeds generated from the selling of public enterprises over the 1998-2002 period. The share, however, goes up to about 29 percent if one excludes privatization proceeds obtained in US dollars. And this is generally a medium term loan where the average loan period is 4 - 6 years and the maximum loan given goes to 7 years. Moreover, the entire loan was provided by the commercial Bank of Ethiopia (CBE), which is the largest bank in terms of the country. Although some

private bank have been established recently, their involvement in financing privatization so far remained nil for reasons to be discussed latter. Of the 34 bank financed privatized companies, 16 constitutes retail trades, 4 are hotels and restaurant and 14 are small scale processing industries, mainly flour mills. In terms of the number, bank financed privatized companies constitute about 17 percent. Most of these loans were also collateralized loans where the average collateral loan ratio, as the record shows, stands at 1.61. In any case, the share of bank financing privatization has been extremely limited even in the privatization of small-scale public enterprises. And prospects of banking participation in the future does not seem to be bright because of several constrains including the liability and asset structure of banks and performance track record of public enterprises.

Table 2

Loan -deposit structure of CBE

	1998 /1999		1999/2000		2000/2001	
	Million Birr	Share %	Million	Share %	Million Birr	Share %
Commercial Bank:						
• Demand	5,503.5	57.3	6,038.2	53.9	6,565.7	55.2
• Savings	3,649.3	38.0	4,584.8	41.0	4,799.7	40.4
• Time	444.5	4.6	570.6	5.0	527.5	4.5
• Total Deposits	9,597.3	100	11,193.6	100	11,892.9	100
• Loans	5056.7	-	6822.1	-	7948.1	-
• Loan/Total Dep.	52.7	-	60.9	-	66.8	-

Types of deposits commonly practice

1. Demand deposits: also known as current accounts its special feature is giving cheque to its clients, there is on any interest on saving.
2. Saving: interest on saving is computed monthly and paid quarterly (transfer to the balance quarterly). The bank doesn't give any cheque to customers.
3. Time /Fixed deposit: is a type of saving in which the customers makes an agreement with the bank to put his/her money for a specific time period i.e the customer can't withdraw his/her money at the time he/she wants money.
 - There is no attractive rate of interest rate of interest on time deposit.

4.1 Major Pitfalls of Privatization

4.1.1. Structure of Liabilities and Lending policies of banks.

A look in to the resource base of the banks reveals several issues if one considers it from the perspective of the need for financing privatization of public enterprises in Ethiopia. Nearly 94% of the savings mobilized by all the banks constitutes demand and saving deposits which are payable at request to customers and are short term maturing liabilities. The share of time deposits, believed to match up with medium and long term loans, stands at about 6 percent. The need to avoid asset-liabilities mismatch. On the other hand, motivate Commercial bank to generally direct their loans to short term maturing and medium term loans. Long term Loans extending beyond five years constitute a limited proportion of the total loans of the commercial banks.

Moreover, except the commercial Bank of Ethiopia (CBE) which has a wide customer base, the saving mobilized by the other private bank is low. A loan to deposit ratio for the Awash and Dashen bank for 1999/2000, for example stood at 87 and 100 percent, respectively showing a sever liquidity constraints of the private banks. The Development Bank of Ethiopia makes limited efforts in mobilization of resources in the form of deposits, but depends on other resources including the CBE and the NBE in meeting credit requests of its customers. The loan to deposit ratio of the constriction and Business Bank (CBB) as well shows that its loan is significantly higher than the deposits

it receives from its customers, suggesting the CBB depends on other sources to meet its normal business activities.

By and large, except the CBE, the rest of the commercial banks operating in the country do not have the capacity even to meet short term maturing loans such as on domestic trade export and import trades. The loan to deposit ratio of the CBE over the last three years range between 53 percent (1998) to 67 percent (2001) indicating the extent of extra resources it has that mainly arose because of significant growth in the deposit of the bank. Its resources base as discussed above however are demand and saving deposits the risk of which is quite clear if one indulges in extending these resources to medium and long term loans including to finance privatization with out a limit. A good number of the privatized companies may constitute an important area of investment and demand for credit for the banking sector. Whether there is a clear policy on the banks to involve in this area in extending loans does not seem to be clear. The financing aspect of the privatization process has not in fact been clearly spelt out even at the national level perhaps partly because this was not an immediate concern, for small shops and hotels and small scale industries might have been thought to be absorbed by the market with difficulty. Problem arises in the case of medium and large-scale enterprises. Because of the absence of special financing arrangement between the privatization Agency and the banking sector, at least in written form, tender winners are left to their own in the search for credit. However, inconsistency in the privatization procedures with banks policies often create serious problems to winners of tenders. Winners have been expected to pay a 30 percent of the money they lend within 10 days for concluding the contract and remaining 70 percent is paid within the next 30 days. Without, that title transfer to the winner would be held bank. But bank need to assured of ownership so as to hold the property as security against their loan. Moreover the new owners have been required by the banks to submit their business assessment including future prospects of the enterprises as condition for the loan approval in such a short time period. These would indeed constitute some significant discouraging elements for the participants as well as of the speed and effectiveness of the privatization process.

The size of resources mobilized via the banking and other financial institution vis a vis the value of the companies to be privatized is another issue that need to be dealt with. Some estimates put the value of the public enterprises for privatization over the next three years at about 40 billion birr. But the saving resource mobilized by the financial sector appears to far below the amount sought for to hand over a sizable number of public enterprise to the private sector. Overall saving of the financial institution which may be taken as approximate to the size of the domestic resource, stands at 12.5 billion birr as of mid 2000. Even if, the whole saving is directed towards financing privatization which is less realistic and assumption, only 31 percent of the estimated value would be absorbed. This tentatively indicates that without an aggressive effort to seek for other modalities of financing, privatization in this country is unlikely to be speeded up as it is desired.

The problem of collateral is too well known to need detailed discussion. Banks require movable and immovable properties as security against their loan requested for. But in most cases, the value of the required security is higher than the loan requested for. Commercial banks in this country generally require a minimum of 100 percent security to extend loans. And, the average collateral-loan ratio of the enterprises privatized using the CBE's loans, for example, stands at 1.61 percent of the required loan. Moreover, are required not only for the initial purchase of an enterprises but also to finance the operating costs so as to keep the companies running. Thus, the asset required as a security for bank loan is likely to have a significant impact on the speed of the privatization process. The types of security acceptable to banks are also limited to buildings and vehicles, and merchandise goods. Factory equipment's and machinery's are excluded because of the absence of an organ responsible for the registration of such properties which would significantly hinder the capacity of prospective participants in the privatization process.

In summary, the most common identified major factors that restrain bank from making potentially more profitable loans to the enterprise sectors are

- Limited information about enterprises current performance

- Considerable uncertainty about their future prospects.
- Lack of expertise in evaluating risk and pressure from the government to improve the quality of bank asset portfolio. These factors lead to low credit to private sector thereby creating a vicious cycle of low output, low enterprise profits, high fiscal deficits and again low credit to enterprises. (Ref. Calvo and kimar)

An expansion of the private sector can not be to materialize with out involvement of the banking sector. In this regard, the banking sector has a paramount role in mobilizing idle funds from the general public and in reallocating the funds those mobilized to sound and viable projects for financing their physical investment and working capital requirements.

These days, the superior significance of the private sector in Ethiopia economy can hardly be overemphasized. It is in full cognizance (awareness) of this crucial importance of the sector that the country's economic policies attach top priority to the enhancement of the sector to bring an efficient way of production.

The development of this sector however, has been constrained by a number of factors of which lack finance is one. The private sector in Ethiopia doesn't have an alternative source of financing when the need for external finance arises. This is mainly due to the absence of both bond and equity markets in the country. As a result bank credit has remained the main source or external finance for many business firms. Apart from the lack of alternative means of financing borrowers in the country are also being unable to make choice between alternative lenders, as the number of lender banks in the country's is very limited.

Until very recently, credit was entirely provided by three state-owned banks, namely the commercial Bank of Ethiopia (CBE) Development Bank of Ethiopia (DBE) and construction and Business Bank (CBB). Among, these, the share of CBE in the provision of credit stood close to 80% through out the 1980s and 1990s. Moreover, as both DBE and CBB were rendering specialized services, the fate of

working capital financing of small business firms and state owned enterprises was in the hands of the CBE.

This situation of credit market has now shown a modest change. This is owing to fact that a number of new and privately owned commercial Bank entered in to the market following the 1992 economic liberalization program and the subsequent deregulation of the financial sector. (Short comings of the Formal Credit Market in Ethiopia)

4.1.2 Absence of a stock Market

Another major financial constraint impending privatization in this country would be the absence of a stock market. As mentioned above, the privatization policy has so far narrowly facades on a 100 percent owner ship upon 100 percent cash payment. This might be fine as far as the small scale trading outlets and industries is concerned, where this strategy has been implemented with some degree of success. But competitive bidding and immediate cash payment would be less feasible to the medium and large scale enterprises. Where success without due consideration to other modes of financing would prove to be difficult. Privatization through the sale of shares to the wider Public has been put in to effect to varying degree in many countries. Among the early starters of privatization, Chile is cited to have extensively used share selling as a means of diverting public enterprises in the 1980s (sader, 1993).

Privatization by selling share to the public may as well create a conducive situation to creation of a stock market. Evidence shows that privatization does play a significant role in the deepening and widening of the size if an existing stock market. The existence of a stock market in turn relatively eases the process of privatization and often serves as a good source of financing and is regarded as on strategy in the privatization process (Freckleton, 1995). Of course, success in this case depends on a number factors including on the prospects of the public enterprises to be privatized, the capacity of the market to absorb the public enterprises offered for sale and strategies adopted in issuing shares.

Loss making enterprises with little business prospects would definitely be less acceptable to the public, provided the latter has the required information. Individuals would commit their resource if significantly convinced that the rate of return they earn

would at least be much as the deposit rate provided by banks. Capacity of the market to absorb the offered shares is another factor determining success. Given the low income of the Country and the small size of the middle income and upper income groups, the share market is likely to be thin and small for some time after its establishment. This is so particularly when viewed against the planned public enterprises to be privatized over the next three to four years. The size of the public enterprises would be large relative to the capacity of the market. Nonetheless, privatization through public offerings of shares together with other modalities may have significant role in the speed of transferring public assets to the private sector. Infact, the absence of a stock market, and public offerings of shares as a part of privatization strategy may have a further attenuating effect on the banking sector itself, as individuals could have financed purchase of shares by borrowing from banks. Moreover, privatization through share offering may enhance public participation in the process. But for the wider public to make a full participation, clear strategies need to be in place. The par value of shares should take account of the income level of the population. The public would make anotable participation if the par value were set low enough. It is also essential to design tax incentives on dividend and capital gains in such a way that encourages the public.

There are also those institution savers such as insurance companies and pension funds generally believed to have long-term surplus money, which can potentially be invested on privatized companies having good business prospects. Currently, the surplus fund of the institutional savers is being invested on treasury bills and government bonds as well as bank deposit, which are generally of low return investments. But the conditions for involving these is not there as sales of shares have not been part of the modalities of privatization in Ethiopia. Equibs and Iddirs has been traditional form of mobilizing resources in the country and could possibly invest on the shares issued as part of the privatization effort. Estimates put the amount of resources mobilized by the traditional financial institutions in Ethiopia at 8 to 10 percent of the GDP (quoted in Bouman, 1995). The decision of course depends on the rate of return equity holdings brings about relative to alternative investments opportunities including the deposits rates offered by banks.

4.1.3 The problem of Valuation

When public enterprises are transferred to private investors, there is a difficulty in valuing the assets and other properties of the enterprises. The EPA devices a value range for enterprises, which are transferred to private ownership. Usually, discounted future cash flows to value the core business of the firm. However, due to the difficulty to forecast accurately, it leads to problems in the future life of the enterprises.

Before a public Enterprises can be transformed into a share company ready for sale to investors, a number of complex operations have to be under taken, in what is known as the preparation phase. As a part of this process all of the fixed assets of an enterprise are revalued in order to reflect more realistic and market-oriented values. The fixed assets of an enterprise may include properties, process plant and machinery such assets are listed in the Asset Register of each enterprise, which records the decreption, date of purchase and cost of every asset. It is a record of the historic accumulation of the assets of the enterprise, and the cost of each asset is subject to national accounting procedures for taxation purposes. These figures are depreciated over the years, so that the figures shown in the books for the current financial year, may have little relevance, in terms of the current value of the asset to the business, on their market value. As time goes by, the relevance becomes less and less. As a result, the current book value' of the assets would be misleading, both to the Ethiopian privatization Agency and to any prospective purchaser in terms of the true value of the assets of the enterprise.

The primary purpose of the asset revaluation is, therefore, to update historic costs, how ever other important benefits also result from the exercise. As part of its preparation process the Ethiopia privatization Agency has established a rolling program in which asset revaluation will be under taken for each of the public enterprise to divested. For the most part, this work is out source to international valuation firms specializing in this filed who have formed partnerships with local counter part firms. The valuation teams visit each enterprise and undertake a physical verification of the assets before carrying out

their calculation. Their efforts result in a certified valuation report for each enterprise which complies with strict international asset valuation standards, yet which reflect the local Ethiopia context with regard to legal environment and market conditions.

The result of the asset revaluation exercise will be to facilitate the financial restructuring of the enterprises by identifying no core, surplus and scrap assets and by providing more realistic asset values by up-dating financial accounts. It will produce a fairer reflection of the assets capable of contributing to future earnings of the business will provide an inventory of assets to be handed-over upon disposal, and it will form the basis for a more attractive package for potential business investors

4.1.4. Track Record of public Enterprises performance.

A number of public enterprises track record proved that they are mismanaged, operating at loss, entailed gross misallocation of public resources and become burden of the government budget. Public enterprises accounted for about half of the fiscal deficit of the consolidated public sector of the country during the 1988-1996 F.Y. (world Bank, 1997). This characterizes many of the public enterprises in Ethiopia particularly the textile sector whose performance worsened as the economy liberalized and become more open. Over staffing, heavy debt burden, entire bank dependency to meet operating costs, high non-performing loan, poor marketing, extreme poor input inventory holdings outdated technology with a frequent breakdown of machines and equipment's are characteristics often made against a good number of PES.

Track record of public enterprise performance has important implication on the decision of the banking sector to extend loans. First, given the technical conditions and overall poor performance of the public enterprises, any loan extended to finance their sale would amount, in a number of cases, to long term loans. Moreover, its repayment depends on the level of investment and efforts made after the handover. A good number of the manufacturing enterprises are of course financially in sound conditions. Paying a significant surplus to the government budget. But in the cases of some PES, privatization

need to be followed by a significant investment activities. A significant capital infusion have to be made. Worn out machines replaced, creaking and leaking buildings repaired and renovated, marketing channels rediscovered existing product upgraded or replaced by new opens and labor issues and working environments straightened before profit is realized and cash flows is raised to a level that would enable to pay back bank debt. But the stream of payoff to this investment might not start to come in immediately and may take some years to reap the full benefits. The feeling is that, in some cases both the loan for the initial purchase and investment after the hand over might amount to establishing a new company. The banking sector, however, has a tradition of hesitation and refrain from involving in long term financing, mainly due to the structure of its liabilities, which are predominately short term maturing. The Development Bank of Ethiopia is the only source of long financing but has liquidity constraints has had been mentioned above. The private banks have come in to the scene only recently and do not have the required capacity to extend loan to financing privatization. Moreover, public enterprises planned for privatization have to compete for bank resources with new investment projects often selected out of many for their economic and financial viability and bank ability.

Secondly, success in the performance of privatized enterprises and the bank debt repayment is not always assured. Their past track record and reputation while in the hands of the government is a factor that would leave banks in doubt and avert to extend loans. Experience else where as well shows that enterprise performance after privatization is rather mixed. Other macroeconomic policies that reduce the market protection structure implemented concurrently with privatization for example are likely to reduce the return and lead to bankruptcy of privatized companies. This was the case in Chile in the late 1970s (Aharoni, 1991). And this appears to be relevant to the Ethiopia situation as the average import tariff rate is generally expected to further decrease in the future as trade policy liberalization deepens. But predicating this trend may not be quite an easy task for prospective financiers and buyers.

4.2 Impacts of privatization

4.1.1 Positive impacts

Privatization program has positive impacts for country like Ethiopia in order to:

- permit government concentrate more on monitoring functions,
- promote private citizens spin-off investment and savings,
- oversee the development of competitive market,
- promote private citizens bear risk, and participate in entrepreneurship and innovation,
- enhance managerial efficiency, cost effectiveness and innovation in business activity,
- maintains balance between government and private sector influence on the national economic productivity,
- increase profitability, efficiency, output, and leads to more investment, etc

4.1.2 Negative impacts

Private investors face difficulties in the areas of availability of technological information and support services, availability of information on exports markets, high and specific collateral requirements for bank loans and lack of manpower with appropriate technical skills leads to some negative outcomes in the privatization process.

Since privatization is short age in Ethiopia and at its early level of development, it is not fully the right time to pinpoint its negative impacts. However, some negative impacts can be possibly discovered. Among these are excessive utilization of manpower. The private firms mostly are more aggressive to their work than to the employees and leads to exploit human labor too much.

Privatization leads to monopolistic nature of firms if there is no competitor in the sectors and loses societal concerns and charge over price to the items the enterprise produce. The market structure in which there is a single seller or producer of a product that has no close substitutes and the firm's that sets price in order to maximize profits forces to monopoly. Being monopoly firm, even with

government help, the power of any single producer is likely to decline in the long run because of long run maintenance of entry barriers is very difficult. Moreover, most of the time all employees engaged or involved in the private firms are relatives (family-wise) of the owner of the enterprises.

CHAPTER -5

Conclusion and Recommendation

This paper has attempted to assess the various made of financing privatization applied in various countries and reviewed Ethiopia's privatization effort and the made of its financing.

In light of the experience of other countries, privatization in Ethiopia has been rather limited to small scale retail trading and industries and has been a relatively slow process.

Although there are several constraints hindering privatization in this country, the following constraints have been highlighted in this paper.

- Structure of liabilities and lending policies of banks,
- The track record of public enterprises performance or financial institution lack enterprises business confidence to promote loans,
- The problem of valuing public enterprises when sale was made to private investors,
- The weak capacity of the market to absorb the sales of offered.
- The mode of privatization has been generally based on a 100 percent ownership upon 100 percent cash. Payment, which is clearly beyond the capacity of the domestic entrepreneurs that, was surprised for too long. Instead, deferred payment system could have encouraged wider participation of domestic entrepreneurs.

The privatization program does not seem to have clearly spelt out all the ways and modes of mobilizing resources to finance the divestment of the enterprises. No special arrangements have so far been made with the banking sector to this effect.

Although the banking sector is the only existing source of credit finance in the country, it is nonetheless less reliable to provide the sort of loans required to effect privatization process. This paper argues that the public enterprises on the agenda for privatization in the next three to four years of large size, and domestic entrepreneurs would require a medium to long term loans to finance their participation. The banking

system, given its deposit base, is short term maturing unlikely to make significant contribution towards that end. Thus, success on the privatization front would substantially be hinged on the effort to mobilize other domestic resources, attract foreign buyers and financial resource.

The past track record of public enterprises performance and, the likely long term loan required to turn them in to financially viable companies even after privatization, would discourage banks from making significant loans towards financing privatization. Lending policies such as the need for collateral to extend loans and the limited type of securities required as a guarantee further limits borrowing to finance privatization in the country.

Privatization is thus unlikely to make some headway with out the adoption of other tested strategies and a combination of incentives for involving the public at large. One clear and feasible mechanism at this stage is privatization through share offerings. This would have allowed a wider asset owner ship among the general public and help mobilize significant resources. Moreover, privatization through sales of share may serve as means to attract foreign investment.

In order to finance privatization process, financial institutions should overcome its general and specific problems mentioned earlier. The government should also launch a micro financing scheme to monetization of the economy. Moreover, it is vital to build a modern and competitive bank, improving the quality of the services, enhancing customer-oriented marketing culture, improving the capacity of training divisions. Establish and develop new loan policy because in recent times a large amount of government money was /is corrupted in banks like the case in CBE. Thus, avoiding giving loans with out sufficient guarantee and future business outlooks. Therefore, credit based on cash flow, capital structure, financial position of the companies and on management skill have been the best procedure to follow in giving loans. Moreover, the government should introduce

and develop stock market and has to transfer public enterprises before they are fully corrupted and develop negative goodwill in the mind of society or the buyers.

Developing policies between financial institutions and the EPA overcomes problems that result when firms shift from a public to private. The buyer as no face problems of finance if there is a established policy between the financial sectors and the EPA in how to give loan or it enable to get access to source of finance.

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Appendix 1

Summary of privatization Transactions in Ethiopia.

May, 1998-June,2002

Category of public enterprises	Number of Retail Shops/ enterprises Privatized	Number of Investors	Proceeds of Privatization ('000 Birr)
I. Ethiopia of public Enterprises	22	8	59,393.3
1.1 Food and General Merchandise Enterprise			
1.2 Shoes and Lather enterprise	19	8	25,372.7
1.3 Building Materials Enterprise	11	5	19,262.2
1.4 Stationary Materials enterprise	7	4	17,155.9
1.2 Textile and leather products Enterprise	15	5	29,780.1
1.3 Automotive and spare parts Enterprise	9	7	26,300
1.7 Meat Retail Shops	4	2	121,031
II. Kuraz publishing Agency	35	4	22,752.2
III. Central Food Storage and Distribution enterprise	4	3	183,590.9
IV. Ethiopia Housing and Office Furniture (EHTOF)	16	11	277,856.1
V. Hotel & Restaurants	14	20	175,204.9
VI. Industrial Enterprises	44	2	2,560,834.4
Total	200	88	3,518,529.8

Source: Ethiopia Privatization Agency.

Appendix 2

Questions to be interviewed

- What is the general and specific objectives of privatization
- How many public enterprises are transferred to the private sectors
- What is the government attitudes to privatization policy
- What is the performance of privatized firms relative to pre privatization
- What is the impact of financial institutions in the process of financing privatization
- What is the side effect of privatization in the economic, social and political aspects of the country
- What are the methods of financing in our country context?
- What type of enterprises is the government sold to local investors and foreign investors



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