

A Proposal for Investment in Eastern Europe

by Eugene H. Rotberg

A lot has been written in recent months about the prospects for foreign direct equity investment in Eastern Europe. The rhetoric runs the gamut from euphoria to dismay. This article describes the current environment and suggests how one might increase the probability of significant benefit both to a host country and to the foreign provider of capital.

We have all read about the "freeing up" of Eastern Europe and the Soviet Union. These countries have skills, pride and hope. Their citizens have produced, over hundreds of years, great writers, artists and musicians, who have graced our lives, scientists and mathematicians. These nations once exercised great power and were held in esteem through diplomacy, compromise, and political acumen. It is just that meaningful economic growth stopped for them about the time of the first World War. They now need capital and technical assistance across a wide range of economic affairs.

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But a long period of stagnation has left them without anchors or guidelines. Indeed, no centrally planned economy has ever made the transition to a market oriented society. For that basically requires that government relinquish control over the allocation of resources and a dismantling of subsidies and support systems. Even purportedly market oriented societies find that a daunting task. It is particularly difficult when there are scores to settle and the infrastructure for governance, public and private, is in the process of being remade.

A market driven system, among other things, demands mobility of labor, open pricing, a credit system, a legal structure and property rights. That is not yet in place. Nor are there sufficient savings to cushion the wrenching transition from a centrally planned economy, with its explicit subsidies and controls, to a market based one. That problem, as we know, has in it the seeds of potential social and political instability. Each constituency nods approval to the benefits of a market based economy, while seeking to retain for itself the preferred access to jobs, food or housing, and to the special privileges which might protect them during a period of unprecedented change. And it's difficult to change a system in bits and pieces while trying to provide for a fair sharing of the country's resources. Some citizens are likely to become quite rich very fast, which is likely to exacerbate a fragile political consensus.

The countries of Eastern Europe have not yet had the time to dismantle the old system, create the confidence needed for a new one, and then slowly develop the systems which provide support during the transition: a social security system, retirement, healthcare, insurance, etc. There is also the nagging spectre that government-designed safety nets in the past have served the few, the elite, through an unfair allocation of scarce resources. The countries of Eastern Europe, in truth, are trying to both dismantle an old system while building a new one without destroying the country in the process -- and in a very competitive and market oriented world.

The problems are compounded by the fact that because of a century of centralized or monarchical control, there is no valuation system currently in place for an outside investor to know what something is worth. Nor does the country itself, given the absence of open market pricing, know the value of what it has to offer. It is not clear who is the owner of the nation's resources. Moreover, there is little liquidity which would permit the transfer of assets once purchased. There are no stock exchanges worth the name, and there are constraints on repatriating profit in scarce hard currency.

Price controls remain endemic for raw materials, commodities, consumers and wages, which have little relationship to their value or scarcity. A reasonably certain structure of taxation is not

yet in place. State subsidies exist for some enterprises or activities, and may remain side-by-side a nascent competing private sector enterprise. And, as much as capital, there is a great need for managerial and technical expertise, along with a system for facilitating saving, providing for credit, and for a means to transfer money and property.

There are uncertainties about repatriation of dividends and the status of capital gains, because the basic concepts of return on equity, profit, credit risk and the time value of money are not yet meaningful. The accounting system is not yet reliable. There is no clear power in central banks to set interest rates as each constituency seeks exemption from the cost of capital. The relative standing of debt versus equity is unclear (as it is in the United States!) -- and the icing on a capitalist cake, stock markets and open disclosure, are in their infancy. In short, the basic social contract in all of its moral and legal aspects, between government and those who own, lend, manage and labor has not yet been struck. Fundamentally, there is no working consensus on the subtle balance of the rights and responsibilities of owners, borrowers, the work force and government -- yet.

There is unsuredness as to who "owns" what, and what "ownership" means. And though some countries are more advanced than others, it remains unclear who in government has authority to strike a binding deal, or grant permission or licenses -- the Central

government, the province, the workers, the managers of the enterprise, a Cabinet Minister. And there is an uncertain legal structure to enforce rights and responsibilities.

There is also hostility, understandably, to absentee landlords coming in and buying industries or services on the cheap. In a given enterprise, on the micro level, the outside investor is likely to find unreliable components and weak quality controls. There is a less than acceptable infrastructure for fax, telephone, mail, transportation, etc.

Despite all of this and, indeed, perhaps because of it, the prospects for substantial economic return to the outside investor and, indeed, to the country itself are, I believe, very great. The key is to make an investment of capital and technical expertise in a manner which addresses these issues directly and openly. The typical investment banker who seeks a mandate to raise funds for investment in Eastern Europe without first knowing how or where to deploy them, I think, makes a mistake. Better to focus on the investment -- the product itself -- rather than raising funds from uninformed insurance companies or pension funds. Nor is it enough to choose a traditional investment manager for investments in Eastern Europe. This is not a business for stock pickers or portfolio managers. The traditional investment manager, domiciled in New York, London, Tokyo, or Hong

Kong, normally has few ties with middle Europe. The typical investment managers normally do not have the resources to identify which of the hundreds of potential investments are wise, let alone the capacity to select those few which are likely to turn out productive. It is more a business for venture capitalists, not portfolio managers. Fewer, still, will have the leverage to negotiate "exits" from direct investments.

There is an alternative approach. I think that, for starters, the foreign investor/banker must have a continuing presence in Eastern Europe. The banker must be prepared to live in the country and become fully involved in the political and social structure of the nation as it evolves. They cannot live in London and jet in and out for lunches with interim finance or planning ministers.

I would suggest that it would be wise, if not indispensable, for a merchant bank to form a joint venture with a local partner, perhaps a development bank or a quasi public agency responsible for economic development in the private sector. The venture should be familiar with what the country needs to privatize, and what the country can produce that the rest of the world will want. They must determine precisely what is the value added of an enterprise which seeks capital or expertise. The banker/investor should understand the transition process the country is going through and probably should be prepared to put in place a partial

safety net for those who would be displaced by more efficient means of production. They should be prepared to use barter to facilitate the savings of scarce foreign exchange to pay for capital improvements. The banker also should be prepared to help mold the transition process and provide counsel and assistance to the highest levels of government. The venture should, in short, have the country's interest in its mind -- including an honest evaluation of what the various enterprises are worth.

Of particular importance, the venture must have access to private corporate expertise anywhere in the world to provide for managerial, marketing, engineering, or research advice to enhance the productivity of the enterprises ultimately selected for investment.

It is my view that, at the early stages, the venture should make investments, if at all possible, only if joined by the International Financial Corporation (IFC), the equity affiliate of the World Bank, or the newly formed European Bank for Reconstruction and Development. These institutions have, or will have in the case of the latter, credibility, objective research and evaluation capacities, leverage to enforce covenants, access to information, and a vast experience which is unparalleled in the private sector. The private merchant bank or corporate enterprise would have no better partner.

The information that is available to the international development institutions concerning the country's infrastructure and its overall economic adjustment program will help focus private sector investment. These institutions will also provide an independent check on the merchant bank's own evaluation of the enterprise. Further, given the fact that the international development banks and their equity affiliates are solely owned by governments, they are likely to be powerful and important partners whose leverage is not to be trifled with.

The participation of a powerful international institution will do much to reduce the risks which will accompany the transition problems the countries of Eastern Europe are likely to face. Further, these institutions will also be involved in providing the resources for the emerging country's infrastructure, coordinating bilateral aid and generally advising the country which sectors of its private economy are likely to be productive in competitive world markets. In short, they simply know a lot about what is going on in the world and are trusted as a provider of quality advice as well as financial resources. They also will put their own money at risk alongside the private investor/merchant bank. And, though not often publicized, they have a remarkable track record for selecting profitable investments.

The costs of a merchant bank placing perhaps two professionals in, say, six capitals is not formidable. (It offers a paradigm, not only for Eastern Europe, but more generally, also for equity

participation throughout the developing world, including the Pacific Rim and Latin America.)

To summarize, I would expect that scores of investments might be made over two-to-three years through a triumvirate made up of (a) a merchant bank domiciled in the country to help evaluate the projects and raise the resources from capital exporting countries, (b) a local partner who knows what is possible to do in the country, who can quickly identify the potentially productive sectors, and who can advise on what regulatory or legal impediments or customs inhibit direct investment, and (c) an international development institution. The merchant bank would have the responsibility to bring in, when appropriate, the industrial or corporate entity from its corporate client base to provide technical or managerial expertise specific to each relevant enterprise.

Certainly, the above format does not guarantee success. Processes never do. It, indeed, may be that the social/political stresses during the period of transition will be such as to tear the countries of Eastern Europe apart, either because of internal stress, or simply the failure to strike and maintain an acceptable consensus between those who own, manage and labor. Or it may be that it is too late to embark in the business of producing a better or less costly product or service the rest of the world wants in competition with those who have had a 50 year head

start. It is arguable that there may be no value added in Eastern Europe given the increasingly sophisticated technical skills all over the world, low wages in Latin America and parts of the Far East and, perhaps most important, the transferability or replicability of even the most sophisticated processes virtually anywhere in the world. This paper, however, assumes that there is room in Eastern Europe (and a few other places) for substantial value added breakthroughs -- particularly in those places where high technical skills, reasonable wage rates, geography, culture, and a sense of opportunism exist.

From the host countries' perspective, they will have to understand that foreign equity investment is not necessarily exploitative. From the investors' point of view, they will have to understand that liquidity, certainly at first, will be hard to come by, and will take some time to develop. Stock exchanges should come later -- much later, after savings, credit systems and property rights have had a chance to develop. Indeed, stock markets do not produce economic growth, savings, or productivity. They are the end product -- the result -- of such developments and, for the most part, offer the prospect of providing liquidity for investments, not resources for growth. Foreign investors also will have to understand that some of the investments will fail because the country falls apart through strife or lethargy, or because they chose the wrong product in a quality and price competitive world. Nonetheless, if there is diversification

across countries and products, if local partners are chosen wisely, and if the international institutions are joined as partners, then the merchant bank and their corporate clients, I believe, over a decade, will find significant rewards, and with those rewards will come the prospect for immeasurably enhanced political stability in the host country.