

My comments here this morning relate to overall direct and portfolio investment in less developed countries, generally, and, in particular, to those but recently coming out of centrally-planned economies, particularly in Eastern Europe, into a world in which they will need and want private capital. Although some of my comments apply to real estate, I will comment more generally on matters relating to the overall environment which foreign equity investors are likely to face.

Though my comments are likely to sound negative, troublesome and involving simply too much hassle for the potential profit, I can assure you that is not my intent. I believe that there is potential for enormous rates of return, if transactions and investments are restructured properly. I believe that we are at one of those rare points in history in which there is a gap between a nation's wage rates and its education, with wages being rather low, the educational level high; between the power of the military to stifle change simply because no one will permit the military, in the foreseeable future, a great deal of power, particularly in Eastern Europe; between the opportunities to have very high rates of return on small equity investment in potentially highly productive industry because (a) there is no valuation system currently in place; (b) there is no liquidity or comparable benchmarks to measure the value of what is being bought; (c) there is enormous need for infrastructure and consumer goods products; (d) for reasons too extensive to be developed here, the commercial banks are on the sidelines, having been shell-shocked because their debt experience has turned out so

badly and, therefore, they are not likely competitors who would push up prices; and (e) there is a sense of wonder and excitement and a desire to give the private sector a chance to make a go of it.

But the problems are manifold:

1. No country has ever shifted from a socialist or centrally-planned economy to a capitalist, or private sector one. Never.
2. There are no certain ways right now to exit from an investment, either a very profitable one or one that is a disaster. There are no stock exchanges worth the name. The constraints on selling out are formidable. But the reason why the constraints are formidable is because the less developed countries -- particularly in Eastern Europe -- do not want to sell out on the cheap, but neither they nor we know what is cheap or dear.
3. There is no safety net in place -- no health insurance, no unemployment insurance, no social security system, nor any labor mobility to cushion the wrenching transition from a centrally-planned economy with all of its explicit subsidies to a market-based one. That problem has in it the seeds of great social and political instability, as

each constituency (while speaking of the need to attract foreign direct investment, private capital, market-oriented measuring sticks), will seek to retain for itself the subsidy, the preferred position and the licenses which, indeed, do cushion the changes to a market system during the shift to a market-based economy.

But let me get back to what one is likely to find as investors in a score of countries now seeking external capital.

- o Price controls are endemic for raw materials, commodities, consumers.
- o Labor mobility doesn't exist.
- o State subsidies for preferred industries or activities are normal, and sometimes will exist side-by-side the private sector.
- o State monopolies over the means of production and, indeed, even in quite small industries have not yet been dismantled.
- o There is little knowledge of how to "privatize."
- o Savings are low.

- o To whom does one sell the stock if there were privatization.
- o Employment in state-owned industries is still extensive. Indeed, the state is the employer.
- o A reasonably certain tax system is not yet in place.

There are, therefore, uncertainties about repatriation of dividends, capital gains, and to whom you can sell off your investment, simply because the concepts of dividends, return on equity, capital gains is not in place, though the process has begun to adopt laws which will provide liquidity.

The ability to sell real estate to a foreigner is severely limited. Indeed, even the ability to own real estate is limited.

- o A legal structure in western European terms is virtually non-existent.
- o The accounting system is weak, uncertain and unreliable.
- o There is no certain power in central banks to set interest rates, as each constituency wants to be exempt from the cost of capital.

- o The currencies are not convertible.
- o There is no tax collection system because the social contract has not been struck as to who pays how much, and for what purpose.
- o The relative standing of debt versus equity is unclear and, obviously, the icing on a capitalist cake -- stock markets, disclosure, regulation, concepts of property rights are not known and certain.

Obviously the more sophisticated concepts, such as depreciation and subsidized borrowings (through tax advantage, tax shelters), are way out on the curve. These nuances on a sophisticated tax structure are irrelevant when the basic structure itself has not been determined.

Let me revert for a moment to the matter of savings. There is little savings, except in the Soviet Union. There is little domestic institutional wealth -- no pension funds or insurance companies, no retirement systems. U.S. banks are out of it as suppliers of equity capital because: (a) they have lost so much money on their debt; (b) they are under profit pressures domestically and find it too expensive to open up a branch system in Czechoslovakia; (c) the German institutions are too close, anyway; (d) banks will finance their own customers to make the

investment, rather than doing it themselves; (e) banks are gun-shy on illiquid investments given their experience in the U.S. real estate markets and LDC debt; (f) regulatory pressures worldwide make it much more difficult for them to make equity investments; and, besides (g) they are reluctant to compete with their corporate clients.

The corporate sector, on the other hand, does not know where to begin to make an investment in Eastern Europe, and, historically, the corporation wants to own the company, not make a 20% investment in it.

Investment managers worldwide, however, (a) have money to invest, (b) are smart enough not to do it alone, and (c) may be modest enough to find a manager who can identify and then make the investments. More on that in a moment.

What will the direct investor find -- the corporate direct investor -- if it decides to form a joint venture. High front-end costs. Uncertainty as to who to talk to. Uncertainty as to who will retain authority. Huge amounts of executive time and management. Hostility to foreigners coming in buying the company on the cheap. A Czechoslovakian Planning Minister told me that the reason why Czechoslovakia will not permit investments of real estate is because they calculated, based on current valuation, that a medium-sized American company (he didn't say whether he

meant a corporation or a pension fund manager) could buy all of the land in Czechoslovakia right now. Further, even if the direct investment is successful and product developed and marketed, there is the risk of accusations of dumping from the United States and, on the other side, a risk that much of the needed high tech stuff will be considered ineligible, for security reasons, for export from industrialized countries.

The company making an investment is likely to find low quality component parts, no marketing or advertising structure, and a less than acceptable infrastructure for telex, fax, telephone, mail, transportation, etc. They are also likely to find a good deal of hostility to absentee landlords, even if it may be, technically, legally permissible by setting up a domestic company. There also will be a lot of uncertainty about who to deal with when one wants to make a direct or portfolio investment -- the Central government, the province, the workers, the managers of the enterprise, the Cabinet Minister -- who is to give final approval. Who can veto. Is it reversible. How does one get out.

It is for these reasons that investment in developing countries, particularly centrally-planned ones, must have on-site a joint venture partner who is domestic. That partner must have the political experience and know-how to get the infrastructure needed to make a company work.

One must make sure the partner will remain in control and that he is not a temporary caretaker put in by a temporary or transition ministry. Direct investors must have access to the highest political levels. The investor must have money to spend, and it must have a very clear plan how the transition will occur from a centrally-planned and owned industry to a privatized one. Who is going to pick up the pieces in the process. Who and how will the safety net be provided. The process of liberalization will be a painful one at its early stages. It is likely the corporate investor will have to develop creative solutions to improving the quality of life of the labor forces in the country.

Profit will have to be very carefully defined. It is an alien concept. It can be expected that state-owned enterprises will compete side by side with private ones. It will be important, therefore, to get licensed permits up front, and to address issues of competition from the state enterprise. The investor will have to understand what happens in the event of failure, and who will bear the burden -- labor, management, or owners. That social contract has not yet been set. Meanwhile, the company will have to get access to roads, electricity, and housing.

The company in which one invests must minimize the need for foreign exchange, or else earn it through exports.

Most domestic companies think the foreigner has unlimited



resources to spend and, therefore, he will ask for escalating prices. One must obtain permission, even to hold foreign exchange outside of the country, and, obviously, have fluency in the language of the country.

For a manager of investments, the problems are virtually the same. The social, political development simply has not progressed to the point of comfort. But then again, we have never had a situation where countries have been in a virtual time warp for over 100 years (starting with a crumbling empire; a ravaging First World War; inflation; depression; a Second World War, followed by the imposition of a centrally-planned economy; military control, to boot), and have never participated in the richness, fullness, riskiness and complexity of modern life!

But the people are there, the cultural, historical sense of power is there. Elegance is there. Skills, pride, hope is there. These are societies which have produced great literature, art, music, physicists, mathematicians. Now they have little time for oppressive government. They just do not have in place a system to create the comfort level for foreigners. And they won't have safety nets as government pulls away. These are countries, whether in Asia or in Europe, which, for the most part, have not been exploitative, though some have, of their own citizens. Literacy, engineering skills are high. These are countries where educating children is considered relevant. Middle Europe was the

center of Western Europe for hundreds of years. It is just that the potential for growth stopped for them in the 19th Century. Now they are open. That is the opportunity.

There are two ways for outsiders to achieve success, despite everything that I have said. One is for a great institution -- a financial institution, probably -- to open up three-person merchant banking venture capital operations with a local partner in each country, perhaps 30 of them, obtain the resources from either pension funds, insurance companies or banks, if they are willing, and out of the hundreds of potential opportunities, choose ten in each country. And take several years to make those choices. After one has considered the stuff I have talked about here this morning, it will create a dynasty of profitability over the next generation. I suspect, it would make even the greatest private wealth pale into insignificance. But there are front-end costs, and it will take time and imagination.

The other route requires less capital and human commitment. It is to link up with those ten institutions in the world who know more about the equity prospects of developing countries than anyone else; institutions with whom most of you have had little contact. These are institutions such as the World Bank, the Asian Development Bank, OPIC, the InterAmerican Development Bank, the new bank to be formed for Eastern Europe -- The European Investment Bank, and a few others, and simply make, alongside of

them, parallel with them, direct equity investments. They have spent years identifying projects and countries to put their equity resources into. The rates of return, for example, of the IFC, the World Bank subsidiary, has ranged between 40% and 50% per year, each of the last four or five years. They have leverage, power and enormous resources. There are guarantees, bilateral and multi-lateral, against a whole range of risks. They have wisdom and are in the process of providing finance, advice and infrastructure and the base for the transition.

All these institutions want to act in a catalytic role for private capital investment. They can enforce contractual agreements, for reasons I can't explain here; they have the expertise and, most important, they know what is going on. They are literally in contact with every Cabinet Minister in every developing country. They know the key is to develop an exit strategy for you -- that is, a way to get out. They also know that unless they work that out, and unless it is ironclad, your money won't go in. I assure you that the German, French and Japanese institutions are working on those exit strategies as to the condition of their making investments. It is do-able.

My comments this morning are basically about how to make a great deal of money, while, at the same time, doing good in the best sense of the word, and laying a foundation for a more stable worldwide political system. It is a remarkable opportunity.