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The PB Newsletter

A Publication of the Privatization Barometer
www.privatizationbarometer.net

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Reporting on privatization in the enlarged Europe

The Rise of Private Equity in Europe,
A Big Leap Forward in China

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THE WEBSITE ON PRIVATIZATION IN EUROPE

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What is the PB Newsletter?

The PB Newsletter is a semi-annual report on privatization activity in the enlarged European Union. It aims at monitoring the most recent trends, at analyzing aggregate data on revenues and transactions, and at providing updated statistics at the country and sector level.

The PB Newsletter highlights the most important deals, which are regularly commented on by privatization guru William L. Megginson. It also hosts contributed articles by top international scholars, who will make accessible to the reader the most recent results of professional research.

The Newsletter also report on the PB indexes, a series of indicators which follow the performance of equity investment in privatized companies in the EU.

Rigorous, updated, easily accessible and freely distributed on the web, the PB Newsletter is an authoritative source of information and a vehicle for a more informed discussion on the choices and consequences of privatization.

Italian Version

Le privatizzazioni in Europa continuano a fare progressi. Nel primo semestre del 2006, 13 paesi dell'Unione Europea hanno realizzato 28 operazioni per un controvalore di 22 miliardi di euro, con un incremento tendenziale rispetto ai risultati del primo semestre del 2005. L'aspetto più interessante del semestre non è l'attività aggregata ma il radicale spostamento nelle modalità di privatizzazione a favore di operazioni di private equity. Per la prima volta dal lancio di PB, le prime cinque operazioni sono collocamenti diretti, che in totale hanno generato l'80 percento dei proventi. I governi attivi nelle dismissioni hanno scoperto che gli investitori strategici e i fondi di private equity sono in grado di lanciare offerte elevate anche per *asset* pubblici di dimensioni rilevanti. Questa tendenza dimostra che i governi hanno oggi una concreta alternativa fra collocamenti diretti e offerte pubbliche di vendita, specialmente quando mercati deboli ed elevata volatilità rendono il *pricing* sui mercati compito arduo per i sottoscrittori.

Anche se si riporta un'attività limitata sui mercati, in termini relativi le società privatizzate quotate hanno mostrato una buona performance. Il PB Composite Index, un portafoglio ben diversificato basato sui titoli delle privatizzate, ha guadagnato 7 punti percentuali in eccesso rispetto al benchmark durante il secondo trimestre del 2006, confermando l'appeal delle società privatizzate quali titoli difensivi in un contesto ad elevata rischiosità.

Un altro aspetto cruciale del semestre è che, contrariamente al passato, una più ampia quota di proventi è stata generata in comparti concorrenziali quali il manifatturiero e l'immobiliare, rispetto ai settori strategici dell'energia e delle utilities. Nel momento in cui la Francia, l'Italia, la Spagna e la Germania sono impegnati in una battaglia transnazionale per il controllo dei giganti europei dell'energia, il rallentamento dei processi di privatizzazione e liberalizzazione a livello nazionale non è sorprendente. Questo atteggiamento difensivo può comunque generare una sequenza di risposte in grado di elevare nuove barriere ai movimenti di capitale e portare a un rinnovato protezionismo, bloccando nell'equilibrio non cooperativo del dilemma del prigioniero i paesi membri. Un maggior coordinamento delle politiche volte alla creazione di veri campioni nazionali europei potrebbe liberare i paesi da questa trappola. Ma chi sarà l'amministratore delegato di queste nuove società? L'emergere di questa ondata di protezionismo che sta attraversando l'Europa adombra un rallentamento del processo di privatizzazione nel breve periodo. Il Privatization Barometer prevede di chiudere il bilancio del 2006 con ricavi totali attorno ai 40 milioni di euro, equamente ripartiti fra i due semestri. Il nuovo contesto economico-politico fa prevedere una significativa correzione rispetto al record realizzato nel 2005. Nonostante ciò, le società privatizzate rimarranno protagoniste sulla scena economica e finanziaria europea.

Mentre l'Europa vive un momento di difficoltà, significativi cambiamenti si stanno prefigurando lontano dai nostri confini e in modo particolare in Cina. L'evento più importante che testimonia questa recente evoluzione è stato la privatizzazione di una delle quattro principali banche, la Bank of China attraverso una gigantesca offerta pubblica iniziale per un controvalore che supera gli 11 miliardi di euro, la quinta più grande IPO della storia. L'evoluzione del processo di riforma delle imprese pubbliche e dello sviluppo finanziario in Cina sono questioni prioritarie nell'agenda delle privatizzazioni su scala globale. PB ha quindi invitato alcuni dei maggiori esperti cinesi ed internazionali ad esaminare gli aspetti più controversi delle recenti trasformazioni che stanno interessando i mercati finanziari cinesi.

La Cina è entrata nel 2001 nella World Trade Organization grazie a un impegno formale di adeguare ed aprire il suo sistema finanziario. Da allora sono state adottate misure importati per mantenere questo impegno, migliorando la *corporate governance* delle imprese quotate, aprendo gradualmente il conto capitale all'investimento estero e adottando misure volte a promuovere la liquidità di mercato, gravemente compromessa dalla presenza di *nontradable shares*.

Questi sviluppi recenti fanno emergere alcune domande fondamentali. Riusciranno queste politiche a realizzare gli obiettivi dichiarati? Riusciranno i mercati cinesi a integrarsi completamente nel sistema finanziario globale? Oppure la portata limitata e la gradualità delle riforme non riuscirà generare alcun effetto di massa critica? Zhiwu Chen, uno dei maggiori conoscitori del sistema finanziario cinese e Professore di Finanza a Yale, offre alcune risposte, inquadrando le più recenti evoluzioni in una prospettiva storica.

Il Professor Chen sottolinea che la dimensione attuale del mercato finanziario, la sua infrastruttura e la rispettiva rete di distribuzione offrono all'economia cinese un notevole potenziale per il finanziamento delle imprese. Il divario tra il potenziale del mercato e la realtà è comunque ancora molto ampio. In particolare, le infrastrutture istituzionali necessarie per sostenere l'investimento finanziario privato sono ancora molto deficitarie. Conseguenza di queste lacune è che, ad esempio, mentre il PIL cinese dall'ottobre 2002 al marzo 2006 è cresciuto a tassi annuali superiori al 9 per cento, il mercato finanziario cinese è sceso del 15 per cento (l'unico mercato del mondo a registrare in termini di rendimenti espressi in dollari una performance negativa).

Questo andamento anomalo può essere spiegato ripercorrendo la storia del mercato finanziario cinese, confrontando l'esperienza recente con il suo passato, risalendo fino ai tempi della dinastia Qing e agli anni antecedenti la nascita della Repubblica Popolare Cinese. La domanda fondamentale è la seguente: in assenza delle necessarie istituzioni legali e di regolazione, quali meccanismi sostitutivi sono emersi in Cina per attirare i piccoli investitori in borsa? Come è stato possibile infondere fiducia nell'investimento azionario? Quanto bene hanno funzionato questi meccanismi sostitutivi nello sviluppo del mercato dei capitali? Nel suo articolo, il Professor Chen ci mostra una tensione continua fra la tipica preferenza cinese nei confronti di regole commerciali informali e relazionali e la dipendenza del mercato finanziario da strutture contrattuali e di *governance* formali. Questa tensione sul mercato rispecchia da vicino le attuali difficoltà che la società cinese sta vivendo nel processo di modernizzazione. Questa tensione ha generato frequenti crolli dei mercati. La storia del mercato cinese riflette la sua storia politica e sociale così come il suo futuro.

Takeshi Inoue, un *senior analyst* di Nomura specializzato nei mercati cinesi, affronta il problema dell'investimento di portafoglio dalla prospettiva del grande investitore istituzionale estero. Egli sottolinea le analogie fra il Giappone degli anni 70 e la Cina di oggi. Da un semplice confronto degli indicatori di sviluppo dei mercati, dei tassi di crescita dell'economia e degli avanzi commerciali, effettivamente i due paesi si assomigliano. Inoltre, il Giappone ha introdotto un regime di tassi di cambio flessibili nel 1973 e ha gradualmente liberalizzato i flussi internazionali di capitale. Le analogie tra la Cina di oggi e il Giappone di allora lasciamo prefigurare che i mercati finanziari cinesi seguiranno le orme del Giappone.

Sebbene in Cina rimangano ancora importanti restrizioni nei movimenti di capitale, alcune di esse sono state gradualmente rimosse. La maggior parte delle principali istituzioni finanziare globali sono già entrate nel mercato e fanno pressione per poter rafforzare la loro presenza. Alcune di queste istituzioni sono entrate nel mercato domestico del *fund managment* che è ancora ad uno stadio embrionale.

Ma prima di mettere le uova in un paniere, bisognerebbe controllare attentamente che non abbia buchi. Così, prima di investire in un mercato bisognerebbe assicurarsi che il mercato non espropri gli investitori delle proprie risorse. Mr. Inoue identifica tre principali ostacoli: *1)* l'eredità del vecchio sistema di quotazione basato su autorizzazione governativa e una scarsa capacità dei meccanismi di mercato di identificare le società che meritano veramente di andare in borsa; *2)* le importanti restrizioni imposte alle società aderenti al programma pilota di trasferimento delle *nontradable shares*; *3)* alcune questioni tecniche nell'area del *clearing* e del *settlement*, dell'intermediazione finanziaria e della tassazione. Nonostante ciò la Cina presenta agli investitori stranieri non solo rischi, ma anche opportunità come il Giappone degli anni 80. Colmare il divario fra gli standard globali e le consuetudini locali sarà la principale sfida del futuro.

Xinghai Fang, un esponente di vertice del governo municipale di Shanghai ci offre una prospettiva dall'interno. La conclusione del suo articolo suona come un allarme per i riformatori cinesi: se la Cina non accelera la liberalizzazione del suo settore finanziario rischia di perdere interamente il mercato. Fang identifica gli aspetti più critici della regolamentazione esistente, quali il limite del 33 percento all'investimento straniero nelle joint venture finanziarie, il loro ambito di operatività eccessivamente limitato, e il rischio di conflitto di interesse fra la joint venture e la controllante in assenza di "muraglie cinesi". Fang poi liquida alcuni tipici argomenti che vengono addotti contro una maggiore velocità nel processo di liberalizzazione, quali ad esempio l'impatto negativo sulle imprese nazionali e l'opportunità di agire unilateralmente nel caso in cui altri mercati (ad esempio gli Stati Uniti nel caso Unocal) non garantiscano condizioni di reciprocità. La sua raccomandazione finale è altrettanto semplice: la Cina dovrebbe andare oltre i suoi impegni iniziali con il WTO e permettere a società straniere di acquisire società finanziare in crisi. Questa politica genererebbe un doppio dividendo: da un lato le imprese straniere, una volta ottenuto il controllo della società, avrebbero finalmente gli incentivi per espandersi nel mercato cinese; dall'altro, si ridurrebbero per lo stato gli oneri finanziari relativi al salvataggio delle imprese. Sul fronte interno, l'industria si potrebbe ulteriormente consolidare attraverso *management buyouts* e promuovendo l'emergere di nuove imprese nazionali e straniere.

L'apertura del mercato è quindi la chiave. Fang conclude che nel mondo globalizzato di oggi l'industria di un paese che rifiuta di aprirsi alla concorrenza internazionale salverà alcuni operatori deboli ma perderà interamente il mercato. Una perla di saggezza cinese, uno spunto di riflessione per i *policy makers* europei.

English Version

Privatization in Europe is continuing apace. During the first semester of 2006, 13 countries of the European Union have executed 28 sales worth €22 billion, marking an increasing trend with respect to the totals of 1H2005. Yet the most interesting feature of this semester is not aggregate activity, but the dramatic shift in privatization methods towards private equity placements. For the first time since the launch of PB, the top five transactions have occurred in private equity markets, which overall raised 80 percent of total proceeds. Divesting governments have discovered that strategic investors and private equity funds can bid very aggressively even for large state holdings. This trend shows that government have today a real choice between private sales and public offerings – especially in times of declining stock markets and high volatility, when fair pricing in public markets becomes a daunting task for underwriters.

Even if we report limited activity in share issuance, privatized companies listed in European equity markets performed well in relative terms. The PB Composite Index, a broadly diversified portfolio based on privatized companies, yielded 7 percent excess returns relative to the benchmark during the second quarter of 2006, thus confirming the appeal of privatized companies as defensive stocks in a riskier environment.

Another key fact of this semester is that, contrary to the past, a larger share of revenues has been raised in competitive industries such as manufacturing and real estate rather than strategic sectors such as energy and utilities. With France, Italy, Spain, and Germany engaged in cross-border economic battles for the control of European power giants, the slowing down of privatization and liberalization processes at the national scale is hardly surprising. However, defensive actions can trigger a sequence of responses that can create new barriers to capital flows and protectionism, trapping member states in the non cooperative equilibrium of the prisoners’ dilemma. More policy co-ordination aimed at creating European national champions would free countries from this trap. But who will be the CEO of the new companies?

This surging wave of protectionism which is sweeping Europe foreshadows a slowing down of privatization trends in the short run. The Privatization Barometer expects to close 2006 with total revenues in the region of €40 billions, thus quite evenly split across the two semesters. The new economic and political environment should make the process bounce back from 2005 highs. Nevertheless, privatized companies will remain pivotal actors in the future European financial and economic agenda.

While Europe is in the doldrums, spectacular changes are taking place far from our borders, and particularly in China. The most recent landmark event has been the privatization of one the four big banks, Bank of China, with a gigantic IPO worth more than $11 billion, the fifth largest initial offering in history. The evolution of State-owned enterprises reform and financial market development in China are fundamental issues in the global privatization agenda. Thus PB has invited some of the top international and Chinese experts to analyze the most controversial aspects of the transformation occurring in today's Chinese financial markets.

China joined the World Trade Organization in 2001 under a commitment to upgrade and open its financial system. Since then substantial steps have been taken to fulfill this agenda by improving corporate governance, by gradually opening the capital account to foreign investment, and by taking measures to boost the liquidity of the stock market adversely affected by the overwhelming presence of non-tradable shares.

These recent developments raise some fundamental questions. Will these policies deliver the expected outcomes? Will Chinese markets fully integrate in the global financial system anytime soon or will reforms be still too limited and gradual to generate any critical mass? Zhiwu Chen, a leading China expert and finance professor at Yale, provides some answers putting the most recent evolution in a historical perspective.

Professor Chen points out that today China has a stock market of a sizable scale and a physical infrastructure and distribution network which presents the Chinese economy with a great financing potential. The gap between stock market potential and reality is, however, still quite large. More particularly, the institutional infrastructure necessary for investors to be willing to part with their money is largely missing or not functioning in its intended way. As a result, for example, the Chinese stock market from October 2002 to March 2006 went down by 15 percent (the only down stock market around the globe over this period, as measured in U.S. dollar returns), even though China's GDP managed to grow by more than 9 percent per year.

These disturbing facts can be explained by looking at the history of stock markets in China and by comparing the recent experience under the current regime with its past under the Qing dynasty and during the Republican years before 1949. The key question is the following: without the necessary impersonal legal and regulatory institutions, what functionally substitutive arrangements did China come up with to induce public investors to begin stock trading? What was done to overcome the confidence and trust barriers? How well have such functional substitutes worked in promoting capital market development? In his article, Professor Chen documents a constant struggle between the traditional Chinese preferences for informal or relationship-based rules of business transactions and the stock market's dependence on formal structures of contracting and governance. This struggle in the capital marketplace mirrors closely the struggle by the larger Chinese society with the process of modernization. It has led to frequent disruptions and crashes in stock trading. China's stock market history thus reflects its modern social and political history. In the same sense, its future will also mirror the social and political future challenges of China.

Takeshi Inoue, a senior analyst at Nomura specializing in Chinese markets, tackles the problem of portfolio investment from the perspective of the foreign institutional investor. He starts by pointing out the similarities between Japan of the 70s and today's China. In a simple comparison by conventional financial market development indicators, growth rates, and trade surpluses, indeed the two countries look similar. Furthermore, Japan changed foreign exchange rates policy in 1973, and gradually liberalized international capital transactions. Because of similarities between today's China and Japan at the time, there are some who expect China's securities market to follow in Japan's footsteps.

Although restrictions on capital transactions still remain in China, they are being gradually lifted. Most major global financial institutions have already entered the Chinese market, and they appear willing to increase their investments. Some of these institutions have also entered the domestic fund management business, which is still at the infant stage in China.

Before placing any eggs in a basket, one should check carefully to make sure the basket has no holes. Likewise before investing funds in a market, one would want to make sure the market was not exacting any rent from its investors. Mr. Inoue identifies three major hurdles: *1)* some legacy of the old government-sponsored listing system, with a too limited ability of market mechanisms to screen out companies truly deserving the IPO; *2)* the important restrictions imposed to companies adhering to the pilot program of transfer of non-tradable shares, *3)* and technical issues in the area of clearing and settlement, brokerage, and taxation. Nevertheless, China presents foreign investors not only risks but also opportunities, as was the case in Japan in the 1980s. Filling the gap between global standards and local practices will be a major challenge for the future.

Xinghai Fang, a top official of the Shanghai Metropolitan Government, provides us with a picture from the inside. The bottom line of his article is a wake-up call for Chinese reformers: China should accelerate the liberalization of the financial sector otherwise it will lose the market entirely. He starts by identifying the most critical aspects of the existing regulation, such as the 33 percent cap on foreign investment in a joint-venture security firm, its too limited business scope, and the risk of conflict of interest between the JV and the parent firm in the absence of effective Chinese walls. He then dismisses some typical counterarguments which are set forth against the faster opening up of the process, for example the negative impact on domestic businesses and the opportunity to act unilaterally when other markets (i.e. the US in the Unocal case) do not grant equal access. His final policy recommendation is also simple: China should go faster beyond initial WTO commitments and allow foreign companies to acquire ailing domestic securities firms against payment of a fee. This policy would yield a double dividend. On the one hand foreign companies, by wielding control of the firm, would be able to expand in the Chinese market. On the other, the government's financial burden to bail out firms would be reduced. On the internal front, the industry could further consolidate via management buyouts and by fostering the emergence of *de novo* domestic and foreign firms.

Opening up is thus the key. Fang concludes that in the globalized world of today, an industry of a country that refuses to open up to competition will save the lives of a few weak players but will lose the whole market. This is a piece of Chinese wisdom and food for thought for European policy makers.

Bernardo Bortolotti

University of Turin and FEEM

Privatization Trends in Europe

Global equity markets experienced a marked downside in 1H2006

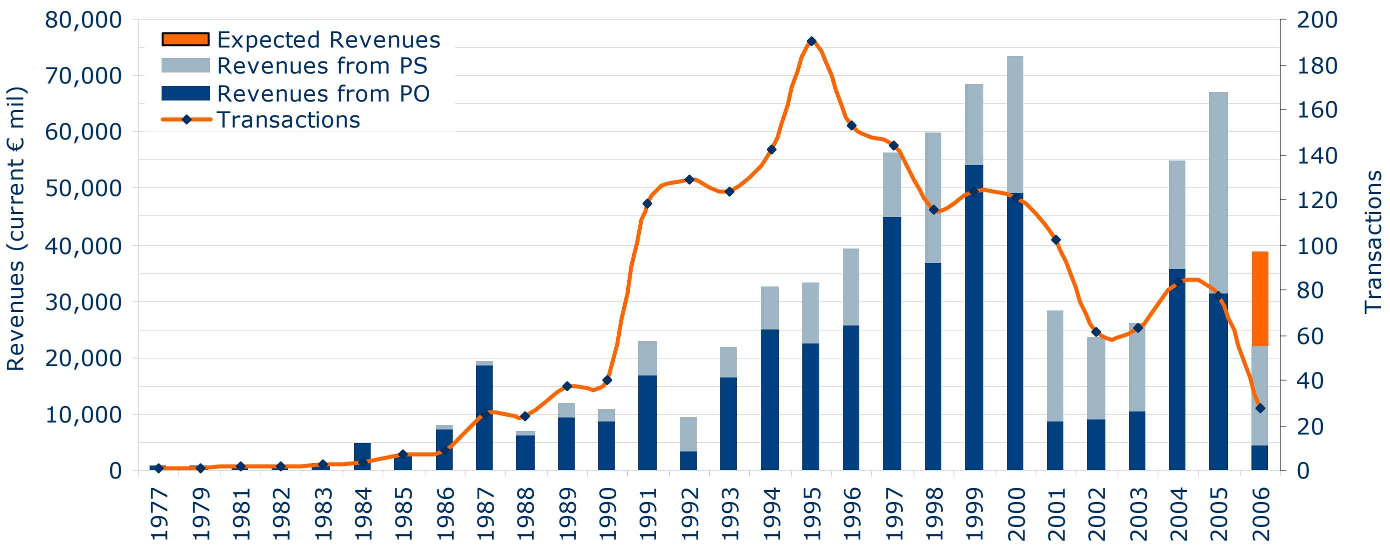
The first semester of 2006 marked a major shift in recent economic and financial trends. Stock markets reopened with a vengeance after the turn of the year and remained in positive territory during most of Q1. April was a critical turning point. Motivated by the serious concerns of global imbalances, multilateral organizations such as the G8 and IMF finally endorsed measures aimed at rebalancing the global liquidity cycle. Raising interest rates was one of the main ingredients of the recipe. Since April 2006, one by one all the world's major central banks, including the ECB, tightened their monetary stance. That was a painful wake-up call for investors. Since the highs in May, developed European markets have plunged by about 10 percent, and emerging European markets have experienced a even more marked downside (from 20 to 30 percent).

Privatization activity, while still intense, is affected by this new scenario

Privatization cycles in Europe followed the unfolding of these events. In 1H2006, privatization activity was significant. The 28 transactions reported in the 13 privatizing countries of the EU yielded €22 billion, marking a 40 percent increase in total value and a 80 percent increase in average deal size with respect to 2005. Yet a closer look at the process shows that the overwhelming majority of revenues have been raised during the first part of the semester, following the recent upsurge of M&A activity. Although some important deals took place also in the new environment, the number of deals started to decrease in response to the market downturn.

Against this background, the most noticeable features of European divestitures in 1H2006 are: *(i)* the boom of private equity placements, *(ii)* the reawakening of

Figure 1. Privatization in the Enlarged Europe: Total Revenues and Transactions, 1977 - 2006



Source: *Privatization Barometer*

two privatization laggards in 2005, Germany and the United Kingdom, *(iii)* the predominance of deals in manufacturing and real estate, after the continuation of the utility binge of the last few years.

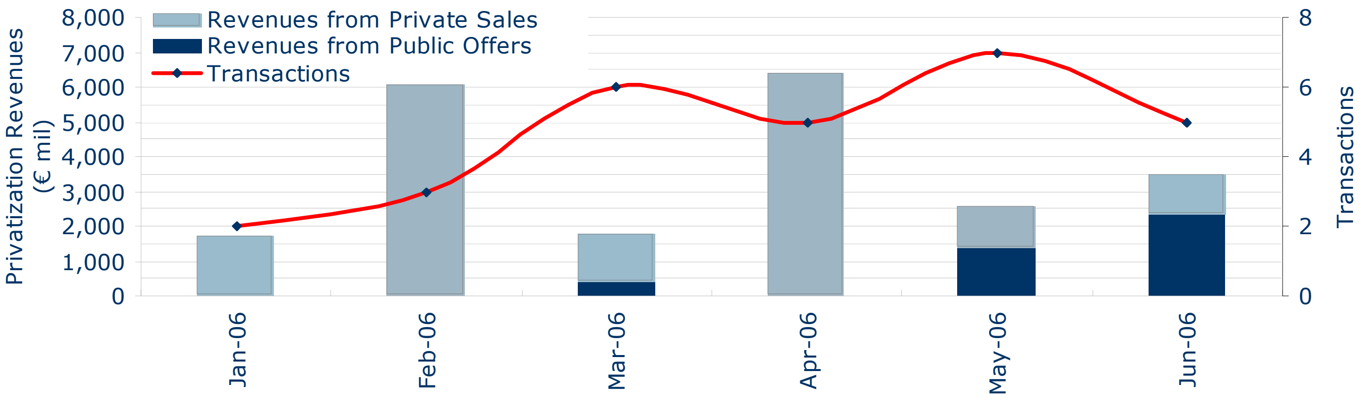
Private equity placements get the lion's share due to huge deals in UK and Germany

As we already mentioned, 1H2006 has been a record semester for global M&A. Private equity backed M&A account for almost 20 percent of total activity, and direct sales by governments or state-owned firms have a strong bearing in that number. The 20 major privatization by private sales raised €17,4 billions, representing 81 percent of total revenues. Interestingly, the top five transactions of the semester are all private equity placements, and they boast impressive deal values. Among these, the €4.5 billion sale of Westinghouse Electric Plc, the US subsidiary of British Nuclear Fuel, to Japan's Toshiba is the fifth largest private sale ever attempted. Other noticeable deals are the block sale of a sizable stake in Deutsche Telekom by KfW, the German fully state-owned financial institution, to the private equity fund Blackstone, and the re-privatization of French Alstom after its brush with bankruptcy (and effective renationalization) in 2003.

Activity in public equity markets strongly declines

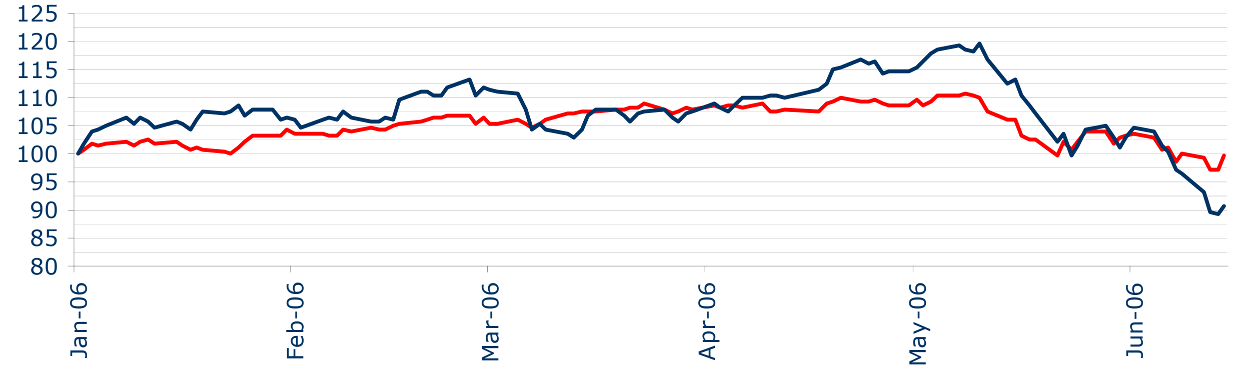
In times of high volatility and declining stock prices the shift to the private equity market is hardly surprising because fair pricing in public offering becomes a daunting task for underwriters. The strong decline in IPO activity is clearly visible in the data. In 1H2006, total IPO value is only €2.8 billion. We report a single large deal, Aéreoport de Paris, raising €1.4 billions, following the wave of large scale privatizations in the transport sector implemented by the French government last year. By the same token, the few secondary offerings identified have almost exclusively taken the form of accelerated transactions to institutional investors, which have gained a substantial market share in recent years. Public offerings earmarked to retail investors have almost disappeared.

Figure 2. Total Privatization Revenues and Transactions in the Enlarged Europe, 1H2006



Source: *Privatization Barometer*

Figure 3. Equity Markets in EU25, 1H2006



Source: Elaborations on *Datastream*

Laggard Germany strikes back…

One of the highlights of the previous PB Newsletter was the lagging behind in 2005 of one of the engines of the European privatization process, Germany. After four consecutive years of decline, German domestic demand finally recovered. On the political front, the grand coalition of CDU/CSU solved the initial uncertainty and found a feasible path for fiscal stabilization. Certainly, privatization and a better economic outlook contributed to relieve the financially stressed German budget. Apart from the above mentioned sale of shares of Deutsche Telekom, drivers of the process have been impressive real estate transactions, such as the sale of 14,800 houses owned by the municipality of Dresden and of the entire portfolio of city-owned offices in Hamburg.

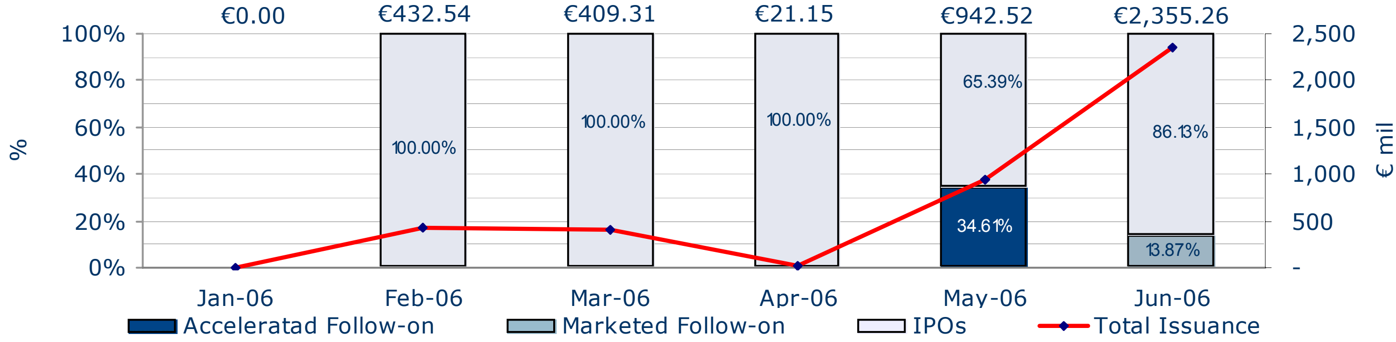
…and the UK is on the move again

Another privatization laggard struck back in 1H2006, the United Kingdom. As is widely known, the country was the frontrunner in privatization activity in the 80s, then progressively slowed down divestiture activity, apparently due to a lack of inventory of privatizable assets. The gigantic private sale of Westinghouse combined with the IPO of QinetiQ, a spin-off by the Ministry of Defence of its non-nuclear research laboratories in a private public partnership with Carlyle group, yielded together almost €5 billions. Indeed, 1H2006 privatization history is truly a tale of these two laggard countries, which together raised half of total revenues.

Strategic sectors lag behind due to a surge of protectionism

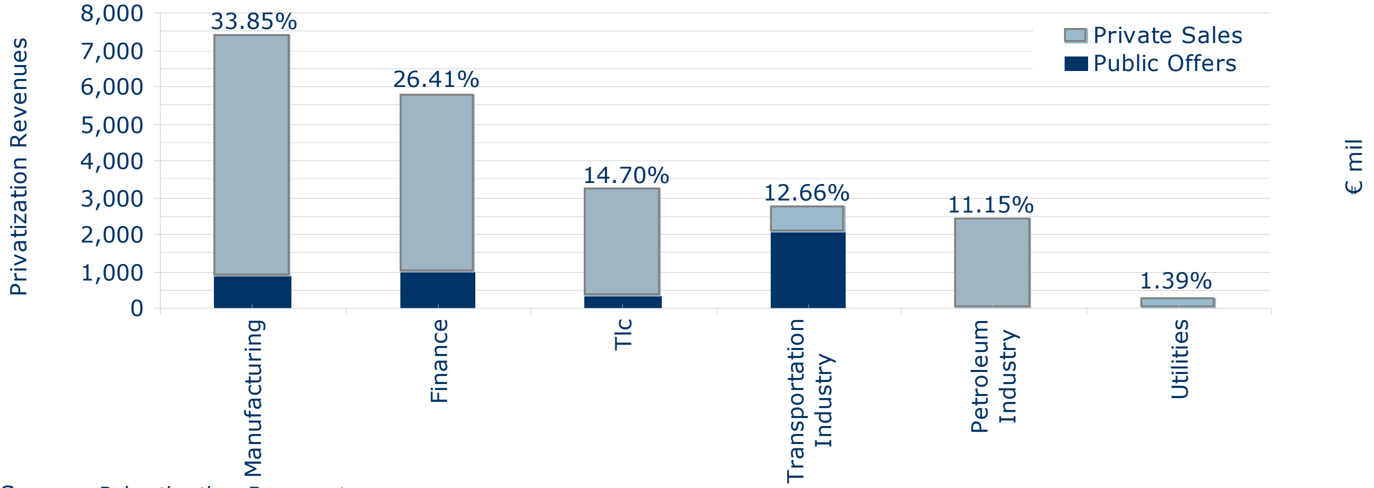
For the first time since the launch of PB, the distribution of privatization by sector is widely skewed towards manufacturing and real estate, rather than strategic sectors such as energy and utilities. This trend is more pronounced in the Old Europe, where revenues in strategic sectors account only for 1 percent of

Figure 4. Share Issue Privatization in the Enlarged Europe, 1H2006



Source: *Privatization Barometer*

Figure 5. Distribution of Privatization Revenues by Sector, 1H2006



Source: *Privatization Barometer*

the total. Again this is hardly surprising because action in strategic sectors is not in the privatization scene but rather in the cross-border takeover markets, and governments of different political stripes are reacting by slowing down divestiture and raising barriers to protect national industries.

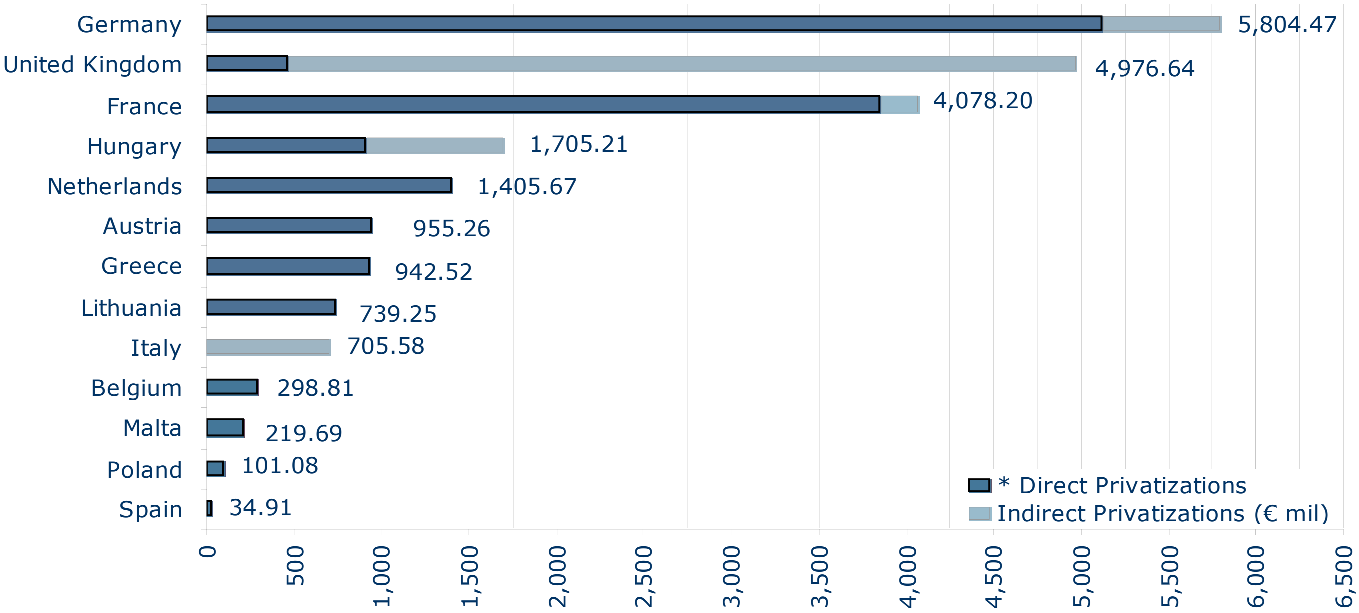
Cross-border takeovers attempts in energy triggered a protectionist backlash

Hard pressed to ensure the security of supply and competitive prices to their consumers, privatized national champions of individual countries have tried to expand abroad by launching ambitious cross-borders deals. The electric Italian behemoth Enel attempted a hostile takeover by bidding for Suez, an energy conglomerate with business in France and Belgium. The German large energy utility E.ON tried another hostile bid on the Spanish Endesa. Both targets thwarted these attempts with the help of white knights such as the recently privatized Gaz de France, and the Spanish Gaz Natural. Both deals are currently underway. Auction theory predicts that the bidder with the most valuable business plan will win the contest and the accomplishment of Mittal's offer for steel giant Arcelor provides a stark illustration of this prediction. Nevertheless, banging at the doors of strategic sectors in neighboring countries typically triggers a protectionist backlash as countries feel threatened in their national security. So the final outcome of these two deals is up in the air, likely in the hands of the EC, and if the going gets tough, of the European Court of Justice.

The country ranking gives the usual picture, with Old Europe getting most revenues and the new accession countries in line with the "10 percent" rule of thumb…

The country ranking confirms the usual distribution of privatization activity. Old Europe gets the lion share: three-fourths of deals and almost 90 percent of revenues. The 10 percent rule of thumb for revenues in new accession countries is again confirmed in 1H2006. Apart from 2005 laggards Germany and the UK, the most recent developments in the French privatization process warrant attention. Thanks to five sizable deals, the French government has raised €4 billions. The total value of deals achieved up to now by de Villepin administration approaches €30 billions, a remarkable record for French standards confirming the role of political orientation in the decision to privatize.
Among the most recent privatizations, the successful private placement of Alstom shows that bailouts are not always money stolen from the coffer but can

Figure 6. Distribution of Privatization Revenues by Country, 1H2006



* Direct Privatizations refer to the sale of government's direct stakes. Indirect Privatizations include spin-offs and transfer of shares from government owned companies.

Source: *Privatization Barometer*

be used to restructure an ailing firm and bring it back profitably to the market. According to recent accounts, the floatation of Aéreoports de Paris is one of the top ten IPOs of the semester at the global scale. Finally, the government has been able to steer to the port, amid strikes and wide social protest, the controversial privatization of SNCM, the ferry operator to Corse.

France privatization heavyweight but…

While it would be hard to question these records on the privatization front, overall the current administration appears keen to stifle financial integration in Europe by blocking the above mentioned takeover bid on Suez and by enacting new legislation to protect strategic national industries. Paradoxically, the merger between Suez and GdF – if it will go through – will trigger the further privatization of GdF, igniting a new dispute which could become another showdown that has pitted de Villepin against unions and lawmakers.

Stalemate in Italy, but sooner or later the privatization agenda will resume

Italy has been one of key driver of privatization in Europe. Yet 1H2006 shows a very limited activity: the only two transactions reported are a spin off of real estate assets by the financial holding company Fintecna worth less than €300 millions, and the IPO of Ansaldo STS (€400 ml). The poor showing of Italy in 1H2006 is attributable to the political uncertainty surrounding April elections, which yielded a split parliament and a highly fragmented centre-left government. Amid difficulties and social protest, PM Romano Prodi has recently launched a liberalization and deregulation package, without announcing any privatization sale. However, it is unlikely that Italy could deal with its fiscal imbalances and towering public debt without resorting to sustained privatization policies in the next future.

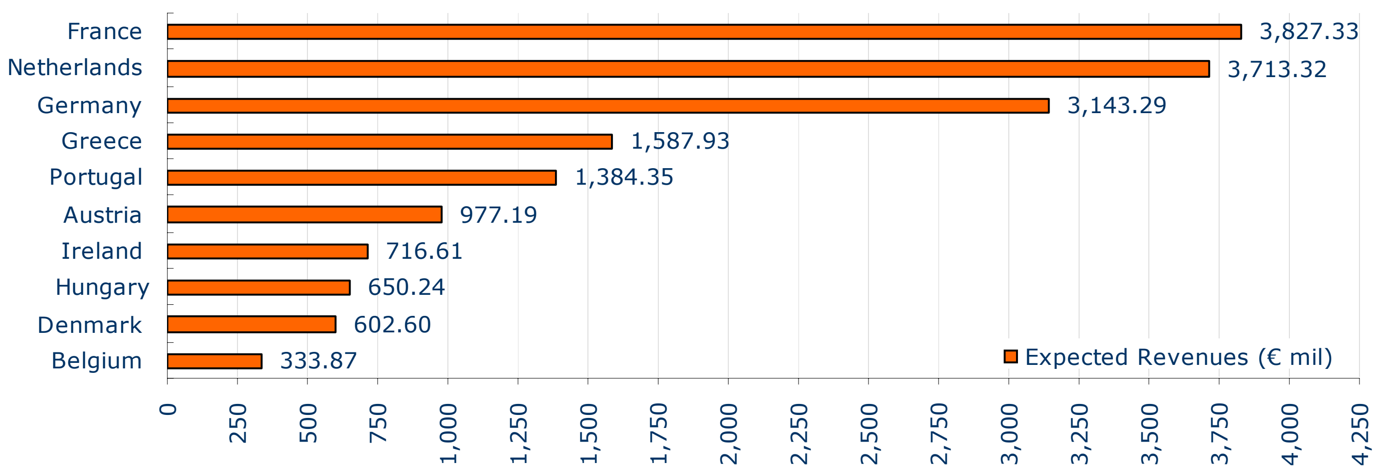
The Hungarian record

Privatization in the New Europe has also slowed down. During 1H2006, seven out of 10 new accession countries did not implement a single sale. In the Czech Republic and in Slovakia, the present stalemate can be ascribed to electoral outcomes, such as split government and the return to power of the socialists, respectively. Overall, actual divestiture is mostly attributable to sales in the oil industry of two countries, Lithuania, and notably Hungary. The Hungarian State Privatization Agency APV has been able to stick to its deadline by privatizing a stake in MOL, the national petroleum company, and two of MOL's main subsidiaries.

2006 will not be a record year

Turning to the regular forecasts on privatization activity, in the previous newsletter, we have correctly anticipated the resumption of Germany, the progress of France, and the stalemate in some transition countries. At the end of

Figure 7. Expected Privatization Revenues in Europe, 2H2006



Source: *Privatization Barometer*

1H2006, we do not revise the forecast stated in the previous PB Newsletter: we expect to close 2006 with total revenues in the region of €40 billions, thus quite evenly split across the two semesters. This number implies a marked downside correction with respect to the previous year due to the uncertain market conditions, a wave of new protectionism setting rules for Europe's games in energy sector, and an easing of fiscal conditions due to improvement on the macroeconomic front.

Indeed, the new economic environment will make privatization bounce back from 2005 highs…

France, the Netherlands and Germany should be the frontrunners in 2H2006. A large follow-on offering of Pages Jaunes should see the light soon, and the Dutch government is expected to come to the market with shares of the TLC operator KPN and Schipol Airport. A sizable deal is also expected in Germany involving Deutsche Post, likely via the usual suspect KfW. As far as new accession countries are concerned, we believe that privatizations will progress mainly in Hungary, which seems firmly committed to entirely divesting its portfolio, while keeping interests only in strategic sectors. Surprises may come from Slovenia, that has recently launched a pervasive pro-market economic program aimed at entering the Euro-Group. To conclude, the new political environment and economic outlook will certainly make the process bounce back from 2005 highs. Nevertheless, privatized companies will remain pivotal actors in the future European financial and economic agenda.

…however privatization will remain pivotal in the future European agenda

William L. Megginson

University of Oklahoma

Major Deals of 1H2006

The Emergence of Private Equity Investors

Private equity groups crave for privatized companies

The first half of 2006 witnessed the emergence of a major new set of buyers of privatized companies: private equity groups, particularly those based in the United States. Private equity groups were the winning bidders in three of the five largest European privatizations of 1H2006, as well as in three of the next eight largest European deals. Additionally, these groups actively bid on several other deals, thus indirectly increasing the net proceeds divesting governments received. All told, private equity investors purchased €7 billion of the €22 billion worth of assets sold by European governments during the first semester of 2006. If, as seems likely, private equity groups retain their new-found appetite for privatized assets – especially for real estate portfolios and regulated utilities – governments will have a real choice between private sales and public offerings for even their largest state-owned enterprises.

Even without any truly block-buster deal, so far EU raised 2/3 of global privatization revenues

The total value of privatizations worldwide exceeded €33.9 billion ($42.3 billion) during the first half of 2006. European Union governments executed 28 sales, worth €21.97 billion, during the January-June period, with 22 of these sales (worth €19.20 billion) coming from Old Europe and the remaining six sales being executed by governments from New Europe. Perhaps surprisingly, none of the European deals was of truly block-buster size, though May's $11.9 billion (€8.95 billion) Bank of China IPO most assuredly was. Six European sales raised at least €1 billion, and seven sales raised €500 million or more. Governments outside of Europe raised over €11.7 billion in five large sales. Since the first two weeks of July witnessed large share offerings by Rosneft and Bank of China (domestic A shares) and Australia has promised to sell its residual 53 percent holdings in Telstra during the second half of 2006, it seems likely that the full-year 2006 global value of privatizations will again exceed €100 billion –and may even surpass 2005's impressive €118 billion ($142 billion) total.

Sales in Old Europe during 1H2006

UK implemented the largest deal with the sale of a BNFL subsidiary

Two of the three largest privatizations in Old Europe during 1H2006 represented a sort of redemption for the governments involved. In February, the British government began the effective dismemberment of the long-troubled British Nuclear Fuels Limited (BNFL) by auctioning off its 100 percent stake in Westinghouse Electric plc for £3.1 billion (€4.51 billion, $5.4 billion). This price represented a very healthy return on the $1.1 billion BNFL paid for Westinghouse in 1999. Toshiba Corporation won the 2006 bidding war, seeing off stiff competition from Mitsubishi and General Electric. Two months later, the French government successfully divested its 21 percent stake in the engineering firm Alstom for €1.98 billion, far higher than expected. Since no

France divested its stake in Alstom

public auction was announced, the French company Bouygues was the sole bidder for Alstom, and this sale was widely interpreted as the government's attempt to build a globally competitive French national engineering champion. The sale also fulfilled the promise France made to divest its stake in Alstom in exchange for EU permission to rescue the firm from bankruptcy by injecting capital into the firm in 2003.

German KfW sold a stake of Deutsche Telekom…

The second, fourth, and fifth largest privatization sales of 1H2006 were all purchased by private equity investors. In April, the German government selected America's Blackstone Group as the preferred bidder to acquire a 4.5 percent stake in Deutsche Telekom. A deal was then struck whereby Blackstone paid €2.68 billion for 191.7 million DT shares at a price of €14 each, a premium of 2.6 percent above the previous day's closing price. Shortly thereafter, Blackstone announced its intention to sell off its German cable-television, internet, and telephone service provider Kabel BW, reportedly to avoid any appearance of conflicts of interest, since Kabel competes directly with Deutsche Telekom. The German government's embrace of Blackstone struck many as ironic, since less than a year earlier a prominent German Social Democratic politician had decried the spreading ownership of Germany's businesses by American private equity investors, likening them to "locusts."

…and the city governments of Dresda and Hamburg sold respectively 48,000 city-owned homes and a commercial property portfolio

n February, the U.S. investment company Fortress signed an agreement to acquire the local residential property company, Woba Dresden, from the city of Dresden (Germany) for €1.75 billion. In a similar transaction that same month, the Hamburg city government sold its 100 percent stake in the Hamburg-Office and Commercial Property Portfolios to private buyers for €816 million. Intriguingly, although at the time of purchase Fortress suggested that Woba Dresden would be retained as an independent entity, and would not be listed on the stock market, barely two months later the company announced plans to float all three of its German real estate under a joint holding company structure early in 2007. The fifth largest European privatization of 1H2006, and the third involving a private equity group buyer, was the January transaction in which a consortium led by CVC Capital Partners agreed to purchase the Dutch waste management company AVR Bedrijven BV from the Rotterdam city government

Table 1. Deals, 1H2006

Date	Company Name	Nation	Sector	Percentage for Sale	Value of Transaction (€ mil)	* Direct/ Indirect Privatization	Method of Sale
02/06/06	Westinghouse Electric Plc (BNFL)	United Kingdom	Manufacturing	100.00	4,507.14	Indirect	Private Sale
04/24/06	Deutsche Telekom	Germany	Telecommunications	4.50	2,677.95	Direct	Private Sale
04/27/06	Alstom	France	Manufacturing	21.03	1,981.25	Direct	Private Sale
04/05/06	Woba Dresden GmbH	Germany	Finance & Real Estate Industry	100.00	1,631.06	Direct	Private Sale
01/11/06	AVR Bedrijven BV	Netherlands	Finance & Real Estate Industry	100.00	1,405.67	Direct	Private Sale
06/16/06	Aéroports de Paris SA	France	Transportation Industry	32.80	1,400.00	Direct	Initial Public Offering (IPO)
05/12/06	MOL Rt	Hungary	Petroleum Industry	10.00	913.74	Direct	Private Sale
02/01/06	Hamburg-Office & Commercial Property Portfolios	Germany	Finance & Real Estate Industry	100.00	816.10	Direct	Private Sale
02/15/06	Mazeiku Nafta	Lithuania	Petroleum Industry	30.66	739.25	Direct	Private Sale
06/09/06	Berliner Bank AG	Germany	Finance & Real Estate Industry	100.00	679.36	Indirect	Private Sale
06/21/06	Österreichische Post AG	Austria	Transportation Industry	41.00	628.53	Direct	Initial Public Offering (IPO)
05/31/06	Postal Savings Bank	Greece	Finance & Real Estate Industry	35.00	616.28	Direct	Initial Public Offering (IPO)
06/05/06	Société Nationale Maritime Corse Méditerranée SA	France	Transportation Industry	75.00	449.97	Direct	Private Sale
02/09/06	QinetiQ Group PLC	United Kingdom	Manufacturing	33.70	432.54	Direct	Initial Public Offering (IPO)
03/24/06	Ansaldo STS (Finmeccanica)	Italy	Manufacturing	60.00	409.31	Indirect	Initial Public Offering (IPO)
03/31/06	MOL Foldgaztarolo Rt (MOL)	Hungary	Petroleum Industry	75.00	395.74	Indirect	Private Sale
03/31/06	MOL Foldgazellato Rt (MOL)	Hungary	Petroleum Industry	75.00	395.74	Indirect	Private Sale
06/23/06	Telekom Austria	Austria	Telecommunications	4.80	326.73	Direct	*Public Offering*
05/12/06	Agricultural Bank of Greece	Greece	Finance & Real Estate Industry	7.23	326.24	Direct	*Accelerated Transaction (AT)*
01/17/06	De Post-La Poste	Belgium	Transportation Industry	50.00	298.81	Direct	Private Sale
03/31/06	Fintecna SpA-Real Estate Portfolio (Fintecna)	Italy	Finance & Real Estate Industry	100.00	296.27	Indirect	Private Sale
03/08/06	ASA Abfall Service AG (EDF)	France	Utilities	100.00	225.83	Indirect	Private Sale
05/17/06	Maltacom	Malta	Telecommunications	60.00	219.69	Direct	Private Sale
04/04/06	ZAT	Poland	Manufacturing	80.00	92.43	Direct	Private Sale
05/15/06	Wyvern Waste Services Ltd	United Kingdom	Utilities	100.00	36.96	Direct	Private Sale
03/01/06	BilboGas SA	Spain	Utilities	50.00	34.91	Direct	Private Sale
04/11/06	ICADE SA (CDC)	France	Finance & Real Estate Industry	3.71	21.15	Direct	Initial Public Offering (IPO)
05/17/06	Elektrocieplownia Zdunska Wola Sp zoo	Poland	Utilities	85.00	8.65	Direct	Private Sale
Total	**28 Transactions**				**€ mil 21,967.28**		

* Direct Privatizations refer to the sale of government's direct stakes. Indirect Privatizations include spin-offs and transfer of shares from government owned companies. Parenteses report the Parent/Seller Company name.

Source: *Privatization Barometer*

for €1.41 billion. This transaction was considered rather unusual in that the bidding consortium did not include an operating company, but instead consisted solely of financial investors.

Successful Privatization IPOs Demonstrate Renewed Investor Interest

IPOs are not huge but successful

Aéroports de Paris lead the value ranking…

The sixth, ninth, and tenth largest Old Europe privatization sales during 1H2006 were all initial public offerings – and all three were enthusiastically received by investors. The largest of these IPOs was the long-awaited listing of Aéroports de Paris (ADP), which occurred in June. This sale involved roughly equal quantities of newly-created shares and existing shares representing about 30 percent of the stake held by the French government. Originally, each tranche was expected to raise €600 million, but demand was so strong that the full Green Shoe option was exercised and the IPO's total value reached €1.40 billion. The offering price was set at €45 per share for institutions and €44 per share for individuals (including employees), who were allocated 50 percent of the offer. The IPO opened strongly, and shares reached €48.80 per share within a week.

Öesterreichische Post is the largest IPO in Austria

And Greece floated on the market the Postal Savings Bank

he two other large Old Europe IPOs were the June sale of Öesterreichische Post (Austrian Post) and the late-May offering of Greece's Postal Savings Bank. The Austrian Post sale was designed to raise €600 million through a pure secondary offering of 45 percent of the shares owned by OIAG, the Austrian state holding company, but demand was so strong that the full 4 percent Green Shoe option was exercised and OIAG actually received €629 million and sold a 49 percent stake. The stock price rose 10 percent above its €19.00 per share offer price during the first day of trading, and then rose to €23.51 per share one week later. The Postal Savings Bank's story was remarkably similar. The Greek government had initially hoped to raise about €500 million by selling 34.5 percent of its holdings in the fully state-owned bank, but was actually able to raise €616 million for roughly the same 35 percent stake. Employees were allocated two percent of the issue at a 10 percent discount to the €12.50 per share offering price whereas foreign, Greek institutional, and non-employee Greek retail investors were respectively allocated 60, 30, and 8 percent of the issue. The offering was 6.5 times oversubscribed.

Berliner Bank has been completely sold-off

The final large privatization in Old Europe during 1H2006 was the long-delayed auction of 100 percent of Berliner Bank by the German state of Berlin, which closed in late June. The EU had demanded in 2004 that Berlin ultimately sell off its holdings in exchange for permission to rescue the bank, which at the time was drowning in bad debts and the repercussions of having made ill-advised loan guarantees. Seven final bidders were culled from the original group of 22, and in the end Deutsche Bank won the auction with an eye-popping offer of €679 million—much higher than the expected price of €450 million. The purchase agreement also included job guarantees for Berliner Bank's current employees.

Sales in New Europe during 1H2006

In New Europe, Hungary is in the middle of the stage reducing its stake in MOL...

As noted above, there were six privatizations by governments in New Europe during 1H2006. Interestingly, three of these sales involved the Hungarian oil and gas company MOL and its subsidiaries, and these were the first, third and fourth largest New Europe sales of 2006's first semester. During May, MOL purchased a 10 percent stake of its own shares from the Hungarian State Privatization and Holding Company (APV) for HUF 238 billion (€914 million), which dropped the state's residual ownership in MOL to a mere 1.7 percent. This one sale allowed the Hungarian government to almost reach its privatization revenue

…and selling right after two subsidiaries of the oil company

objectives for all of 2006. In line with privatization regulations, these revenues will be used to reduce the state's indebtedness, which as a result will remain below the 60 percent of GDP level required by the EU. Along with other international oil and gas companies, MOL's revenues and profits have been surging lately, so it was easily able to fund this share repurchase. Adding to MOL's cash holdings was the sale, two months earlier, of its marketing and trading company MOL Foldgazellato and its gas storage business MOL Foldgaztrolo to the German utility E.ON, which paid €792 million for 75 percent stakes in these two units. The two companies also agreed upon a payment scheme that would adjust the net price paid by E.ON over time based on the evolution of Hungary's gas regulation framework.

Also Lithuania privatize the oil sector

The final large New Europe sale of 1H2006 represented what will hopefully be the last transaction in the tortured history of the privatization of Lithuania's only oil refinery, Mazeiku Nafta. In an attempt to reduce Russian influence over Lithuania's energy supplies, this company had first been sold to the American firm Williams international during the early 1990s. Multiple disagreements between Williams and the Lithuanian government led to cancellation of this contract in 1999, after which Mazeiku Nafta was sold to Yukos in 2002. Though Russian owned, Yukos was at that time perceived to be independent of Kremlin control. This changed dramatically after the Putin government destroyed Yukos as a private company and seized its assets as payment for a large tax debt. The Lithuanian government reacted to this unsettling change of ownership by arranging, in June 2006, for Poland's PKN Orlen to immediately purchase a controlling 30.66 percent stake in Mazeiku Nafta for €732 million. The deal also gives the Lithuanian government a five-year option to sell its remaining stake in Nafta to PKN Orlen.

Sales outside of Europe during 1H2006

Outside Europe, China emerged as the world's largest single privatizer, mainly thank to the huge IPO of BOC

Although, as usual, Europe accounted for the majority of privatization sales during 1H2006, governments in other countries (especially Asia) executed five large sales. In keeping with an evolving trend, China once more emerged as the world's largest single privatizer during the first half of 2006. Early June witnessed the IPO of Bank of China, which raised an astonishing $11.19 billion (€8.95 billion) from the sale of an 11.5 percent stake (after full exercise of the Green Shoe option) of newly-created shares. The retail tranche was 69 times oversubscribed, and BOC shares rose by 15 percent on the first day of trading. Less spectacular, but no less successful, was the April primary share offering of a 3 percent stake in the oil company CNOOC, which raised $1.72 billion (€1.38 billion).

Singapore and Pakistan also executed successful privatizations

Elsewhere in Asia, Singapore and Pakistan both executed successful privatizations during 1H2006. In March, Singapore's state holding company, Temasek Holdings, sold a 4.6 percent stake in Singapore Telecom for $1.34 billion (€1.07 billion), while the Pakistani government sold a 75 percent stake in Pakistan Steel Mill to a Russian-Saudi consortium for $362 million.

And Romania sold a majority stake of its electricity provider Muntenia Sud to Italian Enel

The final large deal of 1H2006 occurred in June, when Italy's electricity company Enel submitted the winning bid for the Romanian electricity provider Electrica Muntenia Sud. Enel paid $1.06 billion (€820 million) for a controlling 67.5 percent stake in Muntenia, representing a direct purchase of 50 percent of the existing stock and a further purchase of 17.5 percent of a planned share capital increase. Enel also committed to investing an additional €380 million to upgrade and modernize its extensive Romanian electricity assets.

Special Focus on the PB Workshop “Financial Market Development in China: Risks, Challenges, and Opportunities”

On Monday April 3rd, 2006, Privatization Barometer has organized jointly with Bocconi University its 2nd annual Workshop entitled “Financial Market Development in China: Risks, Challenges, and Opportunities”.

The workshop, held at Fondazione Eni Enrico Mattei in Milan, has been opened by Eni CEO and FEEM President Paolo Scaroni, and by the Rector of Bocconi University Angelo Provasoli.

Chinese and international leading investment bankers together with top-tier academics have discussed the most recent evolution of the financial landscape in China.

The workshop has been attended by 100 invited participants from the Italian and international economic, financial, and academic community.

We report below some articles based on the speakers' presentations, and a selection of the speeches of the panelists.

Zhiwu Chen §

Yale School of Management

China's Stock Market in Historical Perspective

China today has among the most robust securities market infrastructures in the world

China's stock market today is of a sizable scale. It has almost 1400 listed companies, with a total market capitalization of RMB 3.5 trillion and a monthly trading volume of RMB 364 billion.[1] More than 300 securities and trust companies are licensed to provide stock brokerage services through more than 2500 branch offices in cities, large and small. This extensive network of brokers has attracted more than 73 million stock trading accounts. The 53 fund management companies offer hundreds of mutual funds that are distributed through the vast retail network of thousands of commercial bank branch offices. Together with the advanced electronic trading systems at both the Shanghai Stock Exchange and the Shenzhen Stock Exchange, China today has among the most robust securities market infrastructures in the world, when measured in terms of both trading capacity afforded by the advanced electronic systems and potential investor reach facilitated by the vast physical distribution network. The physical infrastructure and distribution network present the Chinese economy with a great financing potential.

However, the needed institutional infrastructures are still lacking

The gap between stock market potential and reality is, however, still quite large. While China's physical infrastructure for a stock market is impressive by many measures, the institutional infrastructure necessary for investors to be willing to part with their money is largely missing or not functioning in its intended way. As a result, for example, the Chinese stock market from October 2002 to March 2006 went down by 15% (the only down stock market around the globe over this period, as measured in U.S. dollar returns),[2] even though China's GDP managed to grow by more than 9% year over year. To highlight the declining investor confidence in China's stock market, note that in 2005 each month brought in fewer than 100,000 new stock accounts, whereas in 2001 the monthly increase in investor accounts was more than 800,000. [3]

China's stock market history reflects its modern and political history

China's stock market development started from the 1860's, was interrupted several times by wars or by ideology, and re-emerged in the late 1980's. In the discussions to follow, we attempt to compare the recent experience under the current regime with its past under the Qing dynasty and during the Republican years before 1949. Our discussion will center around a key question: absent of the necessary impersonal legal and regulatory institutions, what functionally substitutive arrangements did China come up with to induce public investors to join stock trading? What was done to overcome the confidence and trust barriers? How well have such functional substitutes worked in promoting capital market development? What we will see is a constant struggle between the traditional Chinese preferences for informal or relationship-based rules of business transactions and the stock market's dependence on formal structures of contracting and governance. This struggle in the capital market place mirrors closely the struggle by the larger Chinese society with the process of

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modernization. It has led to frequent disruptions and crashes in stock trading. China's stock market history thus reflects its modern social and political history. In the same sense, its future will also mirror the social and political future of China.

The origin of China's stock market: 1860's to 1911

From the Song dynasty to the 19th century

China is known to have invented paper money dating back to the Song dynasty (960 – 1279).[4] But, it did not venture into innovations in securities trading until the late 19th century. Still, globally speaking, China was not far behind in adopting this financial technology: tradable ownership shares. The question is then: what led to the adoption of the modern corporate form and its twin – stock trading – in China? How did this western financial innovation fit in China's political, legal and social traditions?

National pride and the need to catch up the West spur innovation

China's venture into the stock market and its associated corporate form was largely a consequence of the Self-Strengthening Movement following the defeat in both Opium Wars (1839-42 and 1858-60) to Britain and France (in the second Opium War). The wars taught the Chinese elite a lesson that China was far behind in military technology and that in order to win over the West and regain national pride, China must catch up with western military and industrial technologies. But, adopting such technologies and developing the necessary manufacturing infrastructure required much capital, large sums of capital. Yet, at the time the Qing government was financially constrained. The state would not have the needed resources to take on the projects directly. The financing challenge was therefore daunting.

The "Nanking Treaty" with Britain and the starting of the modernization process

Note that after losing the first Opium War in 1842, China signed the historical Nanking Treaty with Britain. As part of the agreement, China agreed to open five port cities for foreign trade, including Shanghai, Guangzhou, Xiamen, Fuzhou and Ningbo. In the following two decades, British merchants and other nationals moved into the different foreign settlements or concessions in Shanghai. In the 1860's, founders of several foreign-registered joint-stock corporations (such as HSBC, the Union Steam Navigation Co., the Shanghai Steam Navigation Co., and Trautmann & Co.) were able to raise capital by issuing publicly tradable shares to private investors. These examples of stock trading brought to Shanghai by westerners provided a timely idea to the on-going post-war debate in China, that is, you can raise funds through issuing public shares to a large number of investors. It made many Chinese intellectuals and policy advisors conclude that industrial technology and financial technology are what allowed the West to be more powerful.

As one of the leading voices at the time, XUE Fucheng (1838-1894), commented, "The essence of the joint-stock corporation is to make a nation rich and powerful … If a country does not pursue joint-stock companies, its industry cannot prosper nor can its commerce; If China's industry and commerce do not prosper, China will not be rich nor powerful." "Where foreign firms are present, there are corporations raising capital from hundreds or even thousands of shareholders. Backed by plenty of financial resources, no wonder they are so powerful and hard to compete with … This is truly an unprecedented historical change in business." [5] In 1868, an 1854 Yale College graduate (also the first Chinese student who ever graduated from an American university), Yung Wing, proposed to the then governor-general of Liangjiang, ZENG Guofan, to adopt the joint-stock corporate form and start a Chinese-owned navigation company. That idea was well received by the Qing mandarins. China was thus on its way to experiment with the modern corporation and make its shares tradable. But, how could this be done?

The concept of modern corporation relies on the separation between ownership and control, and requires a set of formal legal institutions, as well as a free press…

The modern corporation has three defining characters. First, it is a "legal person", with the same ability to do business and engage in contracting as a real person. Second, it can issue tradable shares to any number of investors. Third, the investors face limited liability (i.e., they could lose no more than their initial investment). At the heart of the modern corporation is the separation between ownership and control, that is, thousands of outside investors (owners) entrust their capital with the management who has actual and full control over the use of shareholder assets. To provide outside shareholders with the needed confidence, this separation has to be supported by a corresponding set of legal institutions, including investor-friendly substantive laws, an independent judiciary and a reliable enforcement infrastructure (Black 2001 and Coffee 2001). In addition, as what is exchanged between the outside shareholders and the corporation is a financial contract (instead of tangible physical goods), there need to be informational institutions, such as a free press and other mass media, to facilitate the uninhibited and fast flow of information. Substantial and truthful information about the stock-issuing corporation is essential for the accurate pricing of its traded shares and for the keeping of investors' trust.

…while in China for centuries personal relationships in business connections have been the essence of economic transactions

Business organizations and economic transactions in China had relied on personal relationships for centuries. Relationships served as a signaling and commitment framework, or as informal bedrocks for trust and a basis for enforcement of contracts (implicit or explicit). Partnerships of unlimited liability were the typical form of joint ownership, with partners from a single family, a lineage, a small number of lineages, or the same locality, usually not going beyond township boundaries. Before the railroad network was built in the late 19^{th} century and afterwards, the lack of mass transportation means prevented for centuries the inland local economies from expanding across regions, generating no pressure for business organizational changes. The waterways in south-east China (Jiangnan) and along the coast could have pressured the unlimited-liability partnership structure and called for more impersonal forms of business organization. However, the emperors' orders forbidding overseas trading since the 13^{th} century and the general anti-commercial Chinese culture stifled the possibility of inter-regional market expansion afforded by the waterways.

China's legal tradition is in sharp contrast with the Roman law tradition

According to Jensen and Meckling (1976) and Easterbrook and Fischel (1989), the modern corporation is simply a "nexus of contracts" or a legal creation. For this "nexus of contracts" to work, there have to be supportive laws and impartial enforcement institutions with enough force. But, as of the late 19th century, China did not have the necessary legal nor informational institutions for arm's-length or impersonal financial contracting, let alone an institutional infrastructure for public trading in financial contracts. In China's legal tradition, the legal system is never separated from, or independent of, the administrative system. In addition, China's tradition put its emphasis on administrative and criminal sanctions, with a lack of formal development in contract, civil liability and procedural laws. Rules and practices did not develop to enforce impersonal contracts or commercial transactions, nor to protect property rights, across regions and beyond local circles. This is in sharp contrast with the Roman law tradition, from which western laws are derived.

A related barrier to China's adoption of the modern corporation was its traditional practice of unlimited liability. Chinese literature classics are often full of stories in which children were held responsible for their parents' or even grand

The modern corporation implies a direct clash with Chinese tradition

parents' unpaid debt, stories of debt being passed down generation after generation. This culture of unlimited liability is even dominant in today's Chinese society. But, limited liability is a fundamental character of the modern corporation, without which passive outside shareholders would not be willing to part with the control of their assets and without which the inside managers would not want to engage in the control because they would not be willing to risk the future of their children and children's children. This is why a sage of the Progressive Era, Nicholas Murray Butler, proclaimed that "The limited liability corporation is the greatest single discovery of modern times" (Micklethwait and Wooldridge 2003, p. XXI). Therefore, the modern corporation would imply a direct clash with one of the defining features of the Chinese tradition.

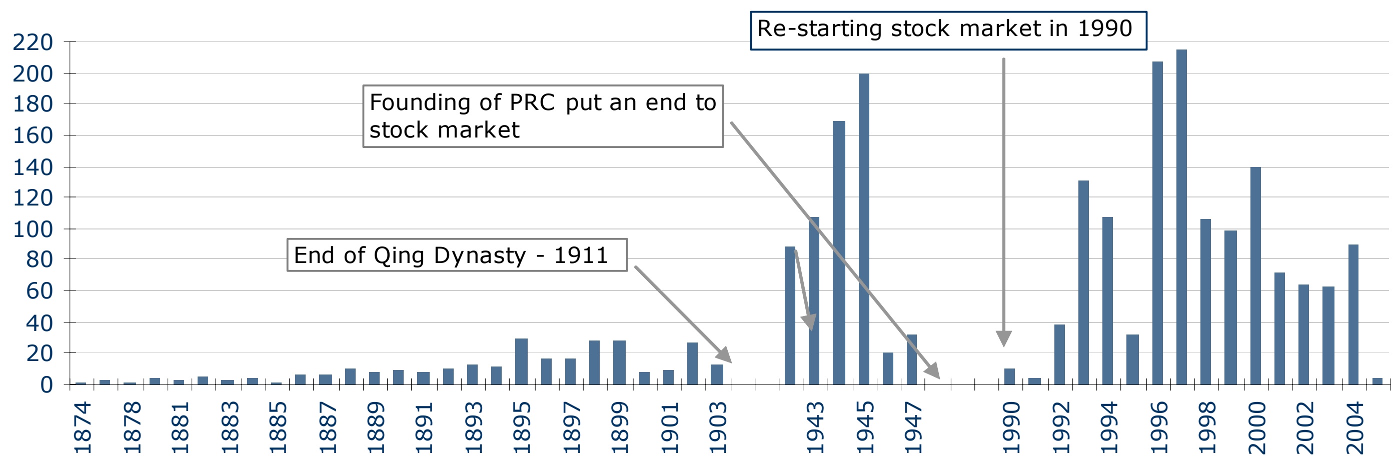
The role of the State in the modernization process

Developing the necessary legal and informational institutions would by no means be a short-term task, even if the elite at the time had known how to do it. Given the urgency of China's modernization movement, the state had to come in and sponsor the new enterprises. In the absence of a corporate law and a bankruptcy law, the government's sponsorship had to include implicit guarantees, limiting the liabilities for outside shareholders and for the corporation. This also marked the beginning of the state's role in corporate management and/or direct corporate ownership in modern Chinese history. Of course, other factors were important as well in the government's decision to become involved in the early experiment with joint-stock companies, including its traditional distrust in private merchants' motives (so the government had to be in, lest the businessmen would exploit the public). Also, the reformer officials were personally interested in ensuring the experiment's success by providing the new enterprises with privileged trade monopolies.

CMC is the first modern Chinese corporation

Take the first modern corporation – the China Merchants' Steam Navigation Company (CMC) – as an example. It was founded in 1872 by LI Hongzhang in his official capacity as the governor-general of Zhili province and a key reformer official in the Qing court. In October 1872, Li appropriated 135,000 taels of Zhili military funds as a government loan to the CMC. But, despite the government's assurance that outside shareholders would receive a 10% government-guaranteed dividend yield, private merchants pledged share capital of more than 100,000 taels but actually paid up only 10,000 in cash. Between 1873 and 1883, the government provided to the CMC annual loan amounts between 80,000 and 1,000,000 taels (Lai 1991). The total of these government loans was 2.2 times the maximum paid-up share capital during this period.

Figure 1. Number of New Chinese Stocks Issued from 1873 to the present



Source: Goetzmann, Ukhov and Zhu (2001) for late Qing, Zhu (2005) for the 1940's, and CSRC website for post-1990.

Overall, the first decade after the founding of the CMC brought 15 joint-stock companies to the market (see Figure 1 for the evolution of new joint-stock companies), from mining, manufacturing and transportation industries. Their shares were traded on the streets and teahouses in Shanghai.

15 new joint-stock companies are established in a decade, and the process continues apace

By the end of the Qing dynasty in 1911, China had had more than 40 years of experimentation with joint-stock corporations and a stock market. More than 480 stocks had been issued for public trading, with many more businesses indirectly benefiting from the stock market. These modern corporations represented a cross section of industries from manufacturing, electrical power, mining, textile, railway, steamship transportation, to banking and financial services. This period of trial and errors made the country's elite recognize the necessity for a government structure that separates the officialdom from the judiciary and from business. In the words of another scholar-official and governor-general of Liangjiang, Zhen Guanyin, "The essence of corporate and commercial laws is to protect business and commerce from the threat of political power".[6] At the beginning of the 20th century, China started to accept the notion of government powers checked and balanced by a constitutional structure.

Stock Market Development in the 20th Century

The founding of the Republic of China

The founding of the Republic of China (ROC) in 1911 led to the adoption of a government structure based on the principle of checks and balances among functional branches and with independent institutions such as the executive (XinZhenYuan), the legislative (LiFaYuan) and the judiciary (FaYuan). It marked a new beginning in China's process toward a modern institutional structure that is friendly to capital market development.

1912-1928: the "golden age" of securities market development

Indeed, the 1912-28 period was a golden age for China's securities market development. According to an estimate by Xu and Chen (1995), during this period, more than 1984 modern industrial and mining enterprises were established each with a capital base of more than 10,000 yuan, with a total investment of 45.89 million yuan; 311 modern joint-stock banks were founded, with a total share capital of 119.43 million. These developments together lifted China's industrial structure to a new level in terms of both scale and scope. Free enterprise under self-regulating professional organizations was the dominating theme of business practice. Professional organizations, such as the Shanghai Native Bankers Association, the Shanghai Securities Broker/Dealers Association, and various other industry associations, and government institutions provided reasonably secure contract enforcement, market conduct and property rights. As a result, a sizable network of financial intermediation emerged with fund-raising capabilities extending beyond geographical boundaries.

After the 1930s, a two decades period punctuated with wars and political-financial crises

The 1930's was marked by bond trading. Then, in 1937 the Japanese occupation troops marched south from Manchuria and China was forced into the 8-year anti-Japanese war (1937-45). Trading in Chinese stocks was soon halted by the government. Between 1937-40 stock trading was confined to the foreign settlement areas in Shanghai and only foreign-registered company stocks were traded. Trading in Chinese domestic stocks resumed in 1940. Figure 1 shows that the year-by-year numbers of new stocks issued were quite high during the post-1940 period, where the data are from Zhu (2005). The pre-war Shanghai Chinese Stock Exchange was re-opened for trading in September 1943.

After the Japanese troops withdrew from China at the end of World War II, the Shanghai Chinese Stock Exchange was closed again in August 1945 and then to re-open in September 1946, this time with just 20 stocks listed. The exchange introduced stock futures and allowed arbitrage trading by the end of 1946. The good time however did not last long, as the stock exchanges in Shanghai and Tianjin were once more halted by the Republican government in August 1948. This time the reason was to give the government enough time to reform its monetary system. After that, the Tianjin Stock Exchange was never re-opened as the Communist troops moved into the city in January 1949. The Shanghai Chinese Stock Exchange resumed operation in March 1949 but was closed in May when the Communist troops marched into Shanghai.

The post-1927 Republican years were therefore punctuated with wars and political-financial crises. As a result, the Chinese stock market went through rounds of stop and go cycles, making it difficult to develop any sustainable equity culture or a functioning institutional infrastructure that is stable enough for reliable shareholder protection.

In 1949 the People's Republic of China is established

The People's Republic of China (PRC) was founded on October 1, 1949. A new economic philosophy of public ownership was to replace centuries-old private ownership. Initially, the PRC re-established a Tianjin Stock Exchange in 1949 and a Beijing Stock Exchange in 1950, with 10 and 6 stocks traded, respectively. But it was soon concluded that the market was too speculative, something that diametrically contradicts the Marxist economic principles. Both stock exchanges were shut down in 1952, and the expropriation of private properties entered its high tide thereafter. By 1958, China was under state ownership, with the private sector making up less than 3% of national output.

Economic reform started in 1978 from the agricultural sector

Economic reform started in 1978, soon after the end of the disastrous Cultural Revolution (1966-76). However, until the mid 1980's the focus of the reform efforts was on the agricultural sector, allowing peasant families to each have a plot of land to grow grain crops and retain whatever profits the peasant was able to generate after sending to the government the required production quota. As a result, there was a large increase in income and living standard among peasants.

The first industrial reform was experimented in the mid 1980s

The success in agriculture then started to affect the debate on how to reform the industrial sector where state ownership dominated. The first industrial-reform experiment in the mid 1980's was to apply the individual-responsibility model of farming to state-owned enterprises (SOE). But, this responsibility model did not work out, since it promoted mostly short-term behavior by management. It was then realized that without clearly defined private ownership, there would not be an incentive structure to induce managers to take a long-term view.

In 1990 the new Shanghai Stock Exchange and the Shenzhen Stock Exchange emerge

In the late 1980's, joint-stock limited-liability corporations became the new experiment, with some SOEs converted into joint-share corporations. These shares were traded on unofficial street markets in Shanghai and elsewhere, much like in the late Qing years. More formally, the new Shanghai Stock Exchange emerged in December 1990, followed by the Shenzhen Stock Exchange two months later. Both then and today, the ownership structure for a typical public company is broken into several share classes: state shares, legal-person shares (only ownable by legal-person corporations), and floating common shares (A-shares for domestic citizens only and B-shares for foreign investors). In particular, the state shares and legal-person shares are not publicly tradable.[7] Regardless of share type, the holder of a share is entitled to the same cashflow and voting rights. Today, a typical public corporation has about one third of its shares in each category of state, legal-person and floating common shares.[8]

Shown in Figure 2 is the post-1990 history of the Shanghai Stock Exchange Composite Index. The peak valuation was reached in June 2001, when the index reached 2218. Since then, it had come down steadily until the bottom near 1000 in July 2005. The Chinese stock market has become the third largest in Asia based on market capitalization (after Japan and Hong Kong). The combined market capitalization of the companies is over RMB 3.5 trillion (about $500 billion) at the end of February 2006,[9] where the tradable shares are priced at RMB 1.2 trillion. Trading is active with a monthly turnover rate of 18.2%. About 20% of the 1377 companies are private firms without the state being the largest shareholder.

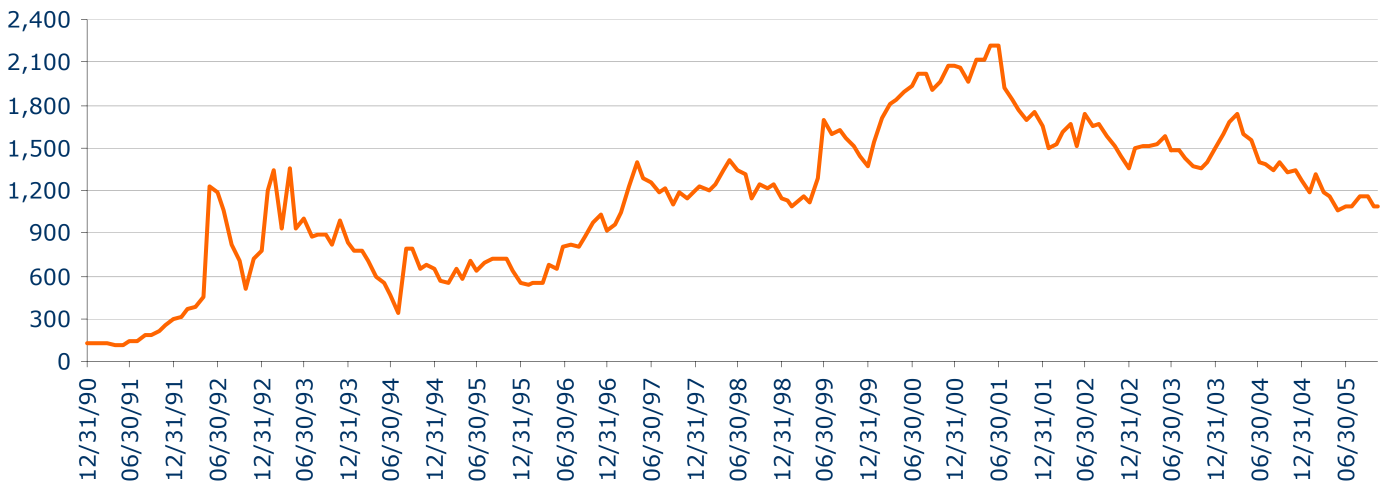
Political and Legal Background in the Recent Experience

150 years later…

Having reviewed the overall picture of the stock market since 1990, we now seek to understand its political and institutional context from which the stock market re-emerged in China. Such an analysis allows us to see whether 150 years later China has finally gotten the stock market "right". Recall that when the Qing reformers started experimenting with joint-stock companies, they went from an economy in which business enterprises were almost all privately owned. During the late Qing, the state's sponsorship was to promote new industries that might otherwise be difficult to launch because of the lack of trust-enhancing legal institutions. In contrast, when stock trading and joint-stock corporations re-started in the late 1980's, almost all enterprises converted into this corporate form were 100% SOEs. The re-emergence of stock shares was because the SOEs had accumulated large financial losses. So the government's intention was to solve the SOEs' financial problems through raising funds from, and selling equity shares to, the investing public. It was not meant to offer the general public a way to participate in wealth creation, diversify investment portfolios or hedge future consumption/income risks.[10] The PRC state was effectively the stock issuer and controlling shareholder. Shareholder rights were more of an afterthought, which became a concern several years after stock trading was widespread.

…the PRC state is the stock issuer and controlling shareholder…

Figure 2. Shanghai Stock Exchange Composite Index



Source: www.SinoFin.com.cn

…and as such, the stock market is designed to promote the state's interest in SOEs…

As an example to illustrate the inherent conflict of interest (that has greatly compromised the state's regulatory and law enforcement roles), note that from 1990 to 2000, the government practiced an IPO quota system for each year, so as to make the IPO flow low enough and push up the IPO prices, setting a perfect environment for more SOEs to issue shares. To achieve this, the government has also needed to maintain a positive and encouraging market through policy announcements and newspaper editorials. The fact that the stock market was designed to promote the state's interest in the SOEs means that the regulator's and even the court's roles are to maintain a high stock price level, instead of ensuring a level playing field for every market participant. In China, neither the court nor the regulators are independent from either the government or the Communist Party. Thus, market regulation is equated with the management of the stock market index.

…ending up with a serious conflict of interest

Note that when the late Qing began its stock market experiment in the 1870's, there was no institutional structure that separated the judiciary from the executive branch and from the legislative branch (judicial independence and regulatory independence would have been foreign concepts back then). Against that background, the Qing government almost had to come in to provide implicit guarantees to the investing public, but the Qing state did not have a direct equity stake in the new enterprises. In contrast, by the late 1980's China appeared to have in place all the modern political institutions from the legislative (the National People's Congress) to the executive branch (the State Council), to the judiciary (the People's Court system), and to the newly adopted Constitution of the PRC. Thus, one would expect the PRC to be much more ready to develop the modern corporation and a stock market in the 1980's. But, as discussed above, the state's stock-issuer role has greatly compromised the functioning of the PRC institutional structure for contract enforcement and shareholder rights protection.

A political compromise led to a settlement of three different classes of shares…

The political philosophy and government structure of the PRC have impaired market development in other ways. Back in the late 1980's, preparation was under way to re-introduce an official stock exchange. But, while stock trading was already taking place on the streets, private ownership and privatization was still political taboo. Against that background, the reformers had to settle for a political compromise, that is, each publicly traded corporation would have several classes of share: state shares, legal-person shares, and floating common shares (A- and B-shares). Making the state and legal-person shares not publicly tradable was supposed to serve two purposes: that no loss of state ownership would occur and that investors in such shares would not engage in speculation (something the communist ideology is totally against). Given that most legal-persons are state-owned or state-controlled, about two thirds of most corporations' shares are owned by the state, directly or indirectly. This ownership structure has not only mis-aligned the interest of different shareholder types (e.g., holders of floating shares can benefit from stock price gains whereas holders of non-tradable shares cannot), but also made it difficult for private securities litigation to proceed independently, because granting damage awards in private litigation would amount to the loss of state assets (to the extent that the state owns a majority of the shares outstanding), which puts the court in a conflicted situation.

…in order to avoid a loss of state ownership and speculation

Another significant obstacle hinge upon Chinese labor culture and concept… but things are changing

Another ideological obstacle to corporate governance in the PRC is the traditional communist value principle that only income through labor is rightly acceptable. Though stock trading appeared in the 1980's, this official line on justifiable income remained in the Communist Party charter until November 2002, when the 16th Party Congress changed the charter to formerly acknowledge that acceptable income can be earned through both labor and capital (i.e., monetary capital, intellectual capital and managerial capital). Therefore, until late 2002, Communist Party members were not supposed to buy or trade stocks; Otherwise, any income from holding shares would not be legitimate. This ideology is of course contrary to the notion of shareholder rights and the protection thereof, which has been partly responsible for the slow implementation of the Securities Law and the Company Law of the PRC. It has been detrimental to the growth of confidence in the stock market.

Future Prospects

Some pressure to improve corporate governance could come from overseas markets…

The administrative or "planned" nature of China's stock market has stifled the market's internal innovative energy, leaving little room for spontaneous institutional development afforded by the high growth pace of China's economy. While access to the limited fund-raising capacity of the domestic stock market has been largely exclusively reserved for the SOEs, the demand for capital by Chinese companies and entrepreneurs has been growing fast. Consequently, a trend has been developing in which more Chinese companies go overseas to issue their stocks on the Hong Kong, New York and other markets. Thus, overseas stock markets in Hong Kong, New York and elsewhere are playing a more important role for corporate China than the Chinese stock market itself. This is apparently putting pressure on domestic market development.

…but developing a deep and liquid stock market is a difficult task not only for China…

Stock markets are easy to set up: one can have some ownership claims issued and traded on a street or in a central physical or virtual location. But, developing a deep and liquid stock market is a totally different matter as it requires all sorts of legal, regulatory and informational institutions. They serve to put meanings and substance to notions such as "fiduciary duty", "fair disclosure", "contracts", "property rights", and "fair value". Since not so many countries have succeeded in putting all these institutions in a reasonable order, there are only a few liquid and deep stock markets around the world. In light of this basic fact, one should not be surprised that as a society in transition from a traditional to a modern nation, China has struggled for almost 150 years to get the public capital market and its associated modern corporate form right.

Challenges might have changed shape through the years but still remain…

When China started its experimentation with the modern corporation in the late 19th century, it is understandable that the government had to come in to sponsor such ventures, providing implicit and explicit guarantees and assurances. Without a formal law of limited liability and fiduciary duty, the government's or officials' sponsorship served as a quick, short-term functional substitute. But, that sponsorship in the end stifled the market's ability to grow endogenously, as the government's sponsorship was transformed into officially sanctioned monopolies and "grabbing hands" instead of "helping hands".

…and privatization will definitely be a starting point in achieving the judicial and regulatory independence of China

A century later in 1990, China's new reformers faced a different challenge than their late Qing sympathizers. Now the state has too many hats: it is the largest shareholder in most of the public companies; it is the rule/law maker; it is the law enforcer; it is the market regulator; and it is the judiciary. All of these roles taken by various state organs that are all absolutely controlled by the Communist Party Central Committee have made it impossible for the judiciary, the market regulator and the law enforcer to be independent. For example, since the state is the largest shareholder in most public corporations, it is hard for the judges and the CSRC to be impartial in adjudication or regulations, respectively. Therefore, privatizing the state-owned shares and the SOEs is a first necessary step to afford the possibility of judicial and regulatory independence in China. Otherwise, China's public capital markets would be difficult to develop. Fortunately, this step has been started and is continuing as the recent tradability reforms for state and legal-person shares have indicated.

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Notes

[1] The statistics cited in this paragraph are all as of February 2006. Source: The Chinese Securities Regulatory Commission, www.csrc.gov.cn.
[2] See Norris (2006).
[3] Source: The Chinese Securities Regulatory Commission, www.csrc.gov.cn.
[4] See von Glahn (2005).
[5] Quoted from page 271 in Li (2002).
[6] Li (2002), p. 100.
[7] A reform policy started in 2005 allowing the listed companies to convert their state and legal-person shares into tradable ones (hence identical to A-shares). By March 2006, about 40% of the 1377 public corporations have completed the conversion. The government's plan is to have the conversion completed for all the companies by the end of 2006.
[8] See Chen and Xiong (2001) for a study on the underpricing structure of legal-person shares. They show that because these shares are not tradable, they are priced at an average discount of 86% to the otherwise identical floating common A-shares. This pricing and liquidity distortion is also a source for corporate governance problems.
[9] The exact market capitalization value for all listed companies combined is a mystery because the state and legal-person shares are not publicly traded and hence no reliable price information can be used to value them. The RMB 3.5 trillion given here is based on the official estimate published on the CSRC website, in which they simply multiply the total number of shares outstanding by the floating A-share price. From Chen and Xiong (2001), this is clearly an over estimate, because the legal-person and state shares are sold at an average discount of 86%. See also Walter and Howie (2003) for another discussion on this market capitalization issue of China's listed firms.
[10] Walter and Howie (2003) argue extensively that the Chinese government's determined interest has really been, and will continue to be, to use the equity capital markets as a tool of enterprise reform, while other by-products of the capital markets have been more of a side purpose.

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Foreign Investment in China: Opportunities and Challenges

A promising market, but still small

A huge potential for growth

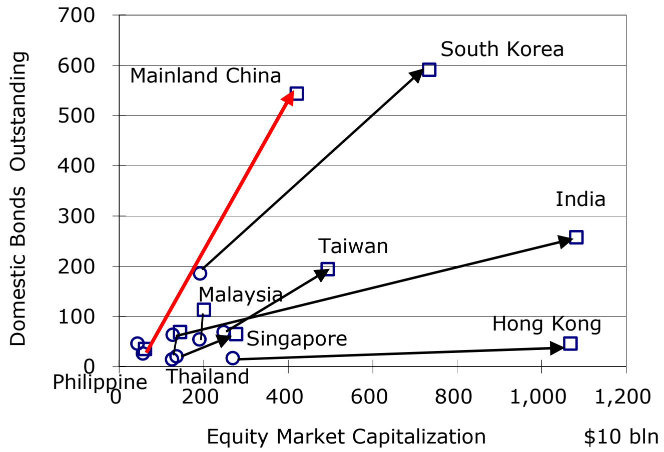
In step with the evolution of its economy, China's securities market has developed rapidly since it was reestablished in the late 1980s, and is already one of Asia's largest markets in terms of stocks and bonds outstanding. Relative to the size of China's economy (GDP), however, the securities market is still small compared with other countries. In other words, the basket is large enough to make investing worthwhile, but there is ample room for it to become larger (Figure 1). With an eye on this potential, foreign investors and institutions are pouring into the Chinese market.

Evidence from the Japanese experience suggests a bright future

The historical development of Japan's economy in the 1970s and 1980s is often referred to in attempts to predict China's future path. In a simple comparison of the two countries by the size of their stock and bond markets, China is at the same level as Japan of the late 1970s based on outstanding volume and of the early 1980s based on trading value. In the 1970s, the Japanese economy was expanding rapidly and consistently generating a current account surplus. Japan changed to a floating system of foreign exchange rates in 1973, the government was running fiscal deficits to support economic development, and international capital transactions were gradually liberalized. Because of similarities between today's China and Japan at the time, there are some who expect China's securities market to follow in Japan's footsteps. Japan's securities market developed rapidly during the 1980s once capital transactions were fully liberalized, but they also wound up generating an economic bubble (Figure 2).

Although restrictions on capital transactions still remain in China, they are being gradually lifted. China introduced the QFII system in December 2002, allowing

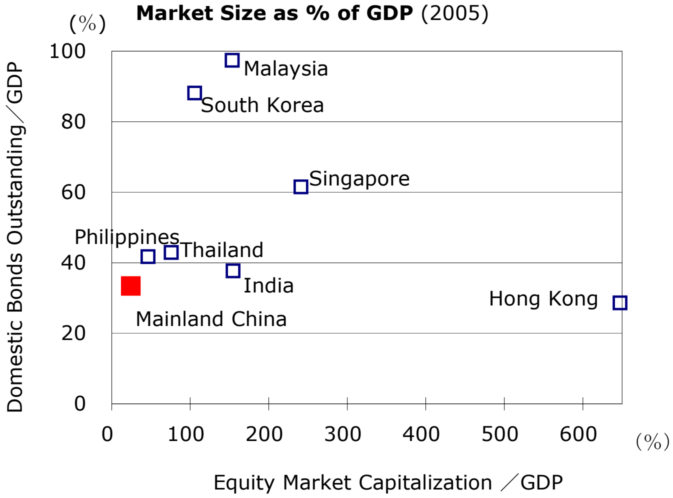
Figure 1. Capital Market Development (1994→2005)



Note: ○ (1994) ⇒ □ (2005)
Data for bonds outstanding as of June 2005

Source: NICMR, based on BIS, WFE data

Market Size as % of GDP (2005)



Note: Data for equity market capitalization as of end-2005, for bonds outstanding as of June 2005, for GDP as of 2004.

Source: NICMR, based on BIS, WFE, IFS data

Overcoming restrictions on capital transactions to foreign investors: the QFII system…

Qualified Foreign Institutional Investors to invest in the A-share market up to a certain quota. So far, 40 institutions have obtained a QFII license and the aggregate investment quota has grown to about US$7 billion, despite the market having remained weak for an extended period until recently. Most major global financial institutions have already entered the Chinese market, and they appear willing to increase their investments.

…and joint ventures

Some of these institutions have also entered the domestic fund management business, which is still at the infant stage in China. The open-ended fund business did not start until 2001. Coincident with China's joining the WTO in 2001, foreign institutions were allowed to enter the fund management business through joint ventures with Chinese enterprises. At this point, 24 of the 64 fund management companies in China are either Sino-foreign joint ventures or companies with foreign shareholders, and together they hold a 25% market share of China's mutual fund industry.

Points to consider

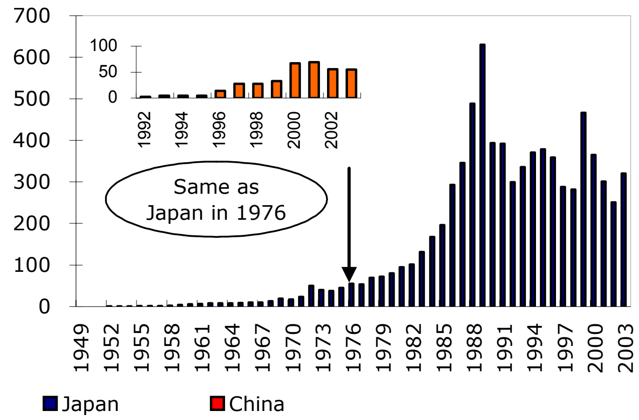
History matters

Before placing any eggs in a basket, you would check carefully to make sure the basket has no holes. Likewise before investing funds in a market, you would want to make sure the market was not exacting any rent from its investors. Like all markets, China's securities market has its own unique set of characteristics and historical background. Because its history is relatively short, however, these characteristics are evolving and in turn exerting a strong influence on how the market develops.

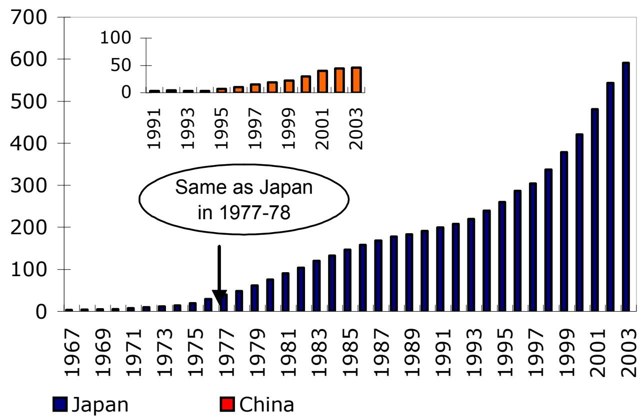
A lack of legacy and competition

The legacy of the listing system is a case in point. In the early days, it was the Chinese government that decided which companies would be listed on the market. Because of the importance placed on funding state-owned enterprises, some poorly managed companies were able to gain listings, companies that would otherwise have been vetted by market mechanisms. The government changed the listing system in 2000, to one in which securities firms recommend which companies should be listed, and a government listing committee makes the final decision. A quota system for the distribution of IPO deals to underwriters remains however in place, and this system, which includes a limitation of eight deals per year for each securities firm, has distorted competition. Underwriters wound up skimping on their of due diligence in order to obtain large IPO deals and use up their quota. There were still companies gaining listings that they did not deserve. The government made further improvements to the listing system in 2003, including a clarification of the listing committee's screening system and a

Figure 2. Equity Market Capitalization



Bond Issuance Outstanding



Source: NICMR

Only 30% of currently listed companies are worth investing in

strengthening of underwriter accountability through the introduction of a sponsorship system in which underwriters were held liable for any frauds committed by issuers. Our point is not that most of the companies listed are poor companies, but merely that it is worth checking on whether the listed companies have gone through the new or old listing system when you invest in. Of course, there are many good companies listed even under the old listing system. But even the government itself has implied that only 30% of listed companies are worth investing in (Figure 3).

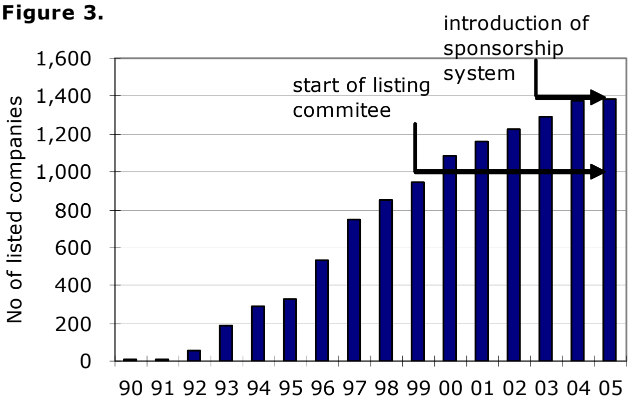
Nontradable shares are the biggest impediment to the development of China's equity market…

…a pilot program of reform has been settled down in order to restructure this system…

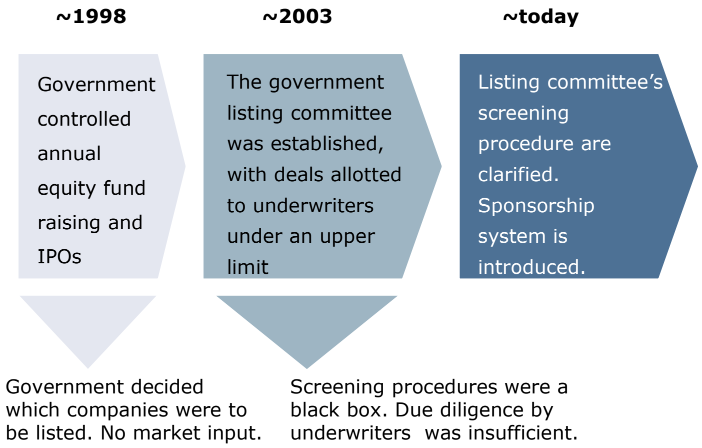
…and gradual improvements are expected after the 2005's reform

The more pressing concern is the status of each company's non-tradable shares. In China, listed companies could issue two types of shares: those listed on an exchange that could be freely traded by investors (tradable shares) and those shares that could not be traded (nontradable shares). The existence of these nontradable shares, which account for more than 60% of all shares issued, has been a major headache for the government and the biggest impediment to the development of China's equity market over the years. The Chinese government implemented a pilot program to reform this split-share structure in April 2005, and extended the program to all listed companies in September 2005. About 1000 companies have implemented the reforms so far. The reform process goes as follows. First, the owners of nontradable shares make a proposal to the owners of tradable shares, a proposal that normally includes compensation in the form of bonus shares and cash distributions, and then the parties enter into negotiations. Provided that the negotiated package is accepted at the shareholders meeting, once the lockup period expires, the nontradable shares become tradable on the exchange. A number of offerings of originally nontradable shares will begin from June 2006, as lockup periods begin to expire. In addition to the lockup period, there are other sale restrictions placed on major shareholders, and thus the offerings that can be expected will depend on the diffusion of ownership. Nontradable shareholders who own more than 5% of the company's outstanding shares may only sell up to 5% of the outstanding shares during the first 12 months following expiration of the one-year lockup period, and only up to 10% during the first 24 months. Because of these restrictions, companies with greater diversification of shareholders should have larger offerings. In addition to these regulatory restrictions, a variety of additional negotiated restrictions can be applied to holders of originally nontradable shares. Many companies, for example, have applied extended lockup periods and selling price restrictions to the nontradable shareholders. In some instances, nontradable shareholders are required to buy shares if the stock price falls to a given level. Because of the variety of these restrictions, the impact of these offerings on the future share price will differ greatly among stocks (Figure 4).

Figure 3.



Source: NICMR, based on CSRC data



Other aspects of the reform imply flexibility and the opening-up to foreign investors

Nontradable share reforms will also have a substantial impact on China's private equity business. Prior to the reforms, companies could only list new shares when they held an IPO, and existing shareholders were unable to sell their holdings. This effectively limited the exit strategy for private equities to corporate transactions. Once this split-share structure is dissolved, existing shareholders are able to sell their holdings through the IPO. China has also eased restrictions on foreign strategic investors as a way to support these shareholding reforms. Under a new rule implemented in January 2006, foreign strategic investors are allowed to purchase A-shares without a QFII license. The initial purchase must be at least 10% of total shares outstanding and they must hold their stake for at least three years. Under these new conditions, the ownership of listed companies will become more dynamic.

Technical issues

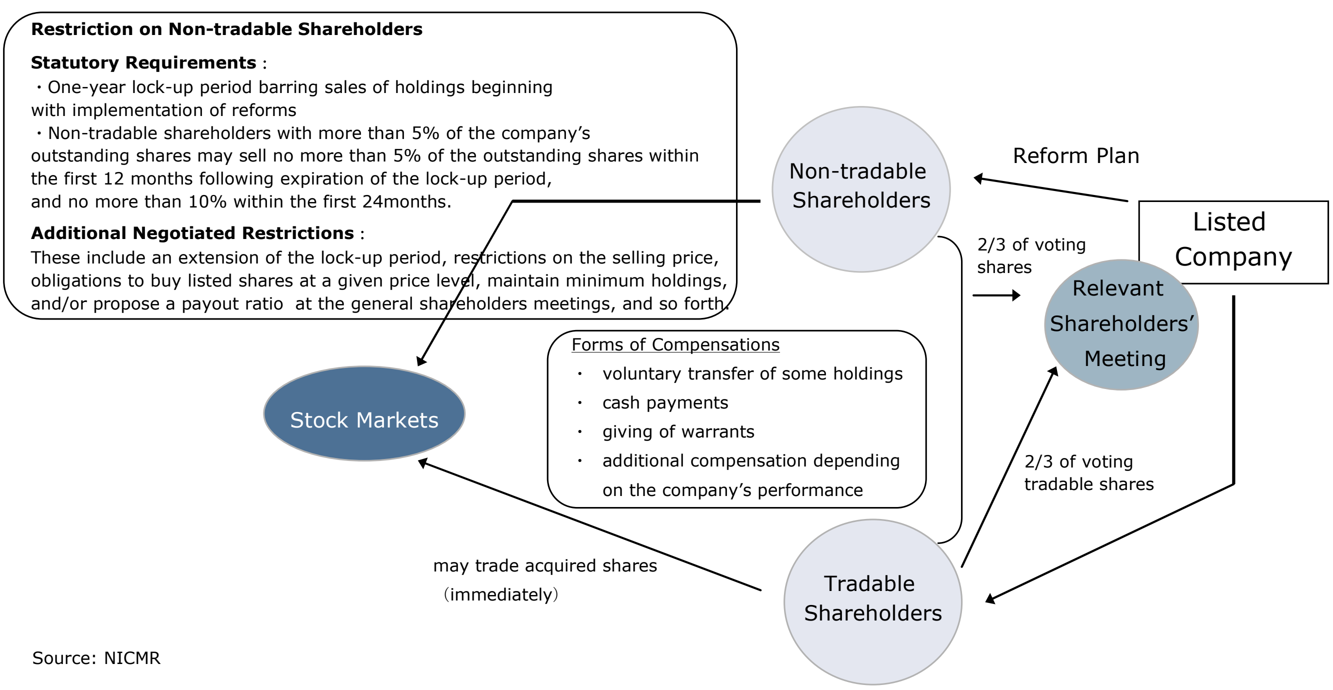
A different timing in the clearing/settlement cycle may require dedicated procedures

There are also some technical issues that investors must keep in mind when considering investment in China. One of these is clearing and settlement. When trading in listed securities in China, delivery is made in T+0 and payment in T+1. This is one of the fastest clearing/settlement cycles in the world. The group of 30 and other members of the global investment community have been trying to shorten this cycle, but most countries still operate on a T+3 cycle. Since most of the systems used by brokers and dealers are based on settlement cycles that are longer than China's, special procedures are needed to deal with Chinese stocks in a timely manner. This is not a problem when investments are small, but material changes to the system will be required when investors make larger and more frequent investments.

A lack of competition affect also the brokerage system

A second issue is the restriction to using several brokers. The rules require QFII to concentrate their orders with a single domestic broker. Since domestic brokers are inexperienced in doing the brokerage business with foreign institutions, investors may encounter problems with their orders. Investors would like to find good brokers through a competitive system, but this is not easy under the single broker system.

Figure 4. Structure of Non-tradable Share Reform



Source: NICMR

Regulation, accounting standards and taxation are other rather delicate issues

The third issue is taxation. The tax treatment of QFII investment has been an open question for some time. Although it is now clear that fund managers will not be levied a business tax, the income tax and capital gains tax on investment has yet to be clarified. Taxation issues are critical, especially when creating investment products for retail investors. Institutional investors are easy to negotiate with because of the limited number of parties involved. This is nearly impossible with retail investors, however. Although issuers and brokers can of course add disclaimers to their prospectuses and other product descriptions, it is much better to have the tax treatment clarified at the outset to preempt any possible disputes.

The nontradable share reforms have also created some technical issues affecting investment in Chinese stocks. For example, nontradable shareholders are using covered warrants and other such rights to compensate tradable shareholders. There may be controversies over the treatment of these rights as securities under the regulations, accounting standards, and tax laws of investors' home markets. If investors are forced to give up these rights, it could create complications and have a negative impact on investment returns.

The important role of "China hands"

Positive changes are expected from the ongoing reform process…

China's securities market has a number of unique characteristics, combined with access to the latest technology, a relatively short history, and the only socialist market economy in the world. It must also undergo some fundamental reforms over the coming years if it is to support China's rapid economic growth. This should mostly result in positive changes to China's securities market, including improvement in both shareholders' market conduct and listed companies' corporate governance.

… the role of analysts with a specialized knowledge of business practices of both China and of the foreign investing country will be key in order to exploit opportunities

Certainly, China should present investors with not only challenges but also opportunities, as was the case with Japan in the 1970s and 1980s. It has always been important to have access to a group of specialists with knowledge of the general system and business practices in both the target country and investors' home country when investing on a global basis, and this is especially true when investing in China. In fact, the bridge-providing role of specialists capable of interpreting systems in both China and the home country is probably much more important than the same role played by specialists on other countries, in light of China's unique history and the speed at which China's securities markets are changing.

Xinghai Fang

Deputy Director-General, Office for Financial Services, Shanghai Metropolitan Government

Opening up of China's Securities Industries

"Now we have set the economic development objectives. But how are we going to achieve them? Well, we need to abide by the principles of social and economic development and pursue two 'opening-ups', that is, opening up to the outside world and opening up within the country itself. Opening up to the outside is important, because no country could develop by isolation. International communication and transference of expertise, technology and capital from the outside is all necessary. Opening up within the country means reform."

-- Deng Xiaoping (April 1985)

Inadequacies of Current Opening Up Policy Concerning the Securities Industry

Current arrangement for opening up of the securities industry is part of China's WTO commitment. It now seems that there are some major oversights in the arrangement.

Limited scope to foreign investors' participation in the Chinese securities market

- *A foreign securities firm can set up operations in China but only in the form of a joint venture, of whose shares it can hold no more than 33%.*

This restriction has turned away many first-class securities firms in the world. The key reason is that as a minority shareholder, they cannot control the joint venture and thus subject their highly valued business reputation to the risk of mismanagement by the JV. Moreover, their status as a small shareholder limits their economic incentives in the joint venture, which in turn prevents them from adequate involvement in the institutional and long-term development of the JV company. A counterargument to this last point is that by opening up we seek to attract management expertise rather than capital. However, without a certain percentage of equity investment, the foreign partner will have too limited concern about the management of the joint venture to have any meaningful influence.

Restrictions on JV may discourage overseas investors to come to China…

- *The business scope of a JV securities firm is extremely limited.*

Currently JV securities firms can obtain a license to become an underwriter and/or a financial advisor. But they cannot operate as a broker or engage in proprietary investment or portfolio management. The extremely limited business scope for these joint ventures reduces foreign companies' willingness to come to China and hurts the competitiveness and long-term earning potentials of an existing JV company, depriving it of the opportunity to provide a full spectrum of services.

…and distort competition

- *Domestic partners for a JV securities firm are limited to existing Chinese securities firms.*

This restriction severely limits the choice of potential domestic partners for a joint venture, especially when we consider that many Chinese securities firms are not well run. A second drawback is the potential competition between the JV company and the parent domestic securities firm. The current solution is to segregate business between the two, with the joint venture specialized in underwriting and the parent firm engaging in proprietary investment, brokerage and portfolio management. However, the expedient has to some extent given rise to two incomplete companies and only served to postpone rather than to solve the potential conflict of interest.

On the contrary, the insurance and banking systems offer a clear example of the benefits that opening-up China's securities industry to foreigners could bring

Indeed, opening up of the securities industry has been painfully slow. Foreign investment is limited. Firms attracted are not the most competitive in the world. The performance of the few joint ventures falls short of satisfaction. Goldman Sachs adopted an ultra-complex model only to ensure management control over its joint venture, but we have to wait to see whether the arrangement works. On the contrary, in the Chinese insurance industry, foreign investors can hold up to 50% of the equity in a joint venture life insurer and a controlling equity in a property insurer. As a result, a good many JV companies have been set up with first-class international insurance companies as partners. As for the banking industry, foreign commercial banks are allowed to have their wholly owned operations in China. The industry will be entirely opened up at the end of the WTO grace period in December 2006. By that time, foreign commercial banks will be able to conduct any banking business anywhere within China. It is not hard to imagine that foreign investment in the banking sector will be all the more vigorous.

Unfounded Concerns About Faster Opening Up in the Securities Industry

Accelerating the opening-up of the securities industry would enhance its competitiveness and strength…

The purpose of accelerating the opening-up of the securities industry is to enhance its overall competitiveness and strength. A frequently mentioned concern about opening up is that major international players would squeeze the less competitive domestic counterparts out of business. An often cited example is the British securities industry, whose key domestic companies were almost all acquired by their stronger foreign rivalries (mostly American firms) following the opening up of the industry in the mid 1980s, though London's status as an international financial center was consolidated as a result.

…without damaging domestic firms because language matters so much

Surely, the British experience is an important precedence for China to consider. However, the opening up experience in Japan, South Korea and Taiwan is very different. Even after these markets were fully opened up, their domestic companies maintained a considerable market share advantage over their international counterparts. The question is then what will happen to China following the opening up? The answer is almost certain. The British and American business communities shared the same language and a too similar culture. Domestic firms have little advantage over their foreign counterparts. But Chinese business environment is distinctively different from that of Britain, and is close to those of Japan, South Korea and Taiwan. In addition, China is a big market. It is quite impossible for a handful of international players to monopolize this market. We should have confidence that Chinese firms will do well in the Chinese market because financial services contain so many local elements. China's telecom equipment and household appliance industries survived and thrived following the opening up of their markets. A more applicable experience is offered by the insurance industry. When AIA entered the Shanghai market in 1992, it grabbed considerable market shares from local companies with its unique method of managing sales. However, domestic companies learned quickly and recovered their lost shares in no time.

The case of India

Even for Britain, it is no exaggeration to say that had it not opened its securities market in the 1980s, and made itself home to major international players, British firms alone would not have been able to keep London a global financial center. Frankfurt or Amsterdam could have overtaken London to become the new financial center in Europe. India offered another positive lesson for opening up. The Indian securities market opened in 1992 with no restrictions on foreign shareholding or scope of business. Today, the Indian market is considered on a par with those of developed countries, though foreign companies accounted for no more than 40% of the market share. Moreover, as time goes by, domestic companies are likely to grow in their relative strength.

No market opening, no domestic brand names

A second concern about opening up is that China would be deprived of a chance to build its national brand names in the securities industry. A commonly cited example is the Chinese car industry. However, the real reason that China has no leading brand names in cars is not because the industry was opened up too quickly but because foreign auto builders were allowed to enter into partnerships only with Chinese state-owned enterprises. These state-owned firms have neither immediate urgency nor long-term incentives for innovation. From the 1950s through the 1980s, the auto industry in China was totally closed and what lasting national brand did we have? The long-forgotten "Shanghai" or the still struggling "Red Flag"? Had foreign car makers be allowed to team up with top private companies in China, we would have seen Chinese brand names a long time ago, because only wholly self-owned brands can bring in lucrative profits.

China should move unilaterally without asking reciprocity for its own benefit

A third concern about opening up is that the Chinese securities industry may end up in a disadvantaged position if the opening up is unilateral while other markets fail to give us equal access. We believe, however, that the primary issue in making the policy decision is whether opening up is beneficiary to our own industry. If the answer is yes, we should pursue it. Whether or not we will receive equal treatment in a foreign market is a separate issue. In addition, we would think that Chinese securities firms are not yet ready to test their muscles in a market such as New York or London. When CNOOC failed in its bid for Unocal, some people suggested that we should slow down the opening up of China's financial industry. We would ask these people that if somebody made himself a fool by hurting his left foot, must we hurt our right foot so as to retaliate?

Recommended Ways to Accelerate Opening Up in the Securities Industry

Need to go beyond WTO commitments

The necessity of opening up is well argued by Mr. Deng Xiaoping as quoted in the beginning of this essay. The three restrictions listed in the first part are China's minimum WTO commitments, but we have never said that opening up of our securities industry could not go beyond our commitments or proceed faster than we had promised. Considering the current conditions of our domestic securities companies, a preferred model for accelerating opening up would be allowing foreign companies to acquire for a fee ill-operated domestic securities firms that are on the brink of bankruptcy. After acquisition, the foreign company will inherit the business licenses of the acquired domestic firm and obtain controlling shareholding within the new firm. The model is attractive to foreign companies because it allows them a full license, control over the new company and access to the expanding Chinese market at the limited cost of compensating the historical losses (or even part of the losses) of the acquired domestic firm. At the same time, the model reduces the financial burden on the Chinese government to bail out losing securities firms. The new companies born out of such acquisition will usually improve on management and competitiveness.

Accelerating Internal Opening Up

Proposals for steering up reforms

Mr. Deng Xiaoping pointed out as early as in 1985 that to open up within the country is to adopt reform. Almost all securities firms in China are still state-owned or state-controlled. It was not until a few years ago that some private companies became the controlling shareholders in a couple of securities firms. However, driven by majority shareholders' short-term interest in an environment of weak regulation, these privately controlled companies (such as Fuyou, Deheng and Hengxin Securities) committed a series of violations. But I believe, this should not be a reason to slow down reform. In light of the shortage of regulatory capacity in the near future, effective reform can be achieved in the following manners:

Increasing management shareholdings

- *To make senior and departmental managers shareholders of their own securities companies.*

One proposal is to start with management acquisition of some company shares with their own cash. Later on, management shareholding is to be increased by converting part of the incremental net assets of the company into equity. This is probably the best way to heighten risk awareness of securities firms and to increase their competitiveness against foreign rivalries.

Stimulating Chinese citizen's entrepreneurship

- *To allow securities professionals of Chinese citizenship from within or outside China to establish new firms.*

Licensing can start with brokerage-only firms for which limited capital investment and a few key sponsors are required. The success of a securities firm depends on quality professional leadership. Over the last few years, the Chinese securities market has seen a good number of well-qualified professionals with extensive operation experiences. If these people are allowed to set up their own firms, no doubt some high-quality companies will soon emerge.

Planning the right pace of the opening-up process is key for its success

The result we are looking forward to is domestic securities firms (and asset management firms) holding a majority market share in a fully opened Chinese securities market. For this reason, we have to carefully plan for the pace of the opening up process so that domestic companies will be able to maintain their advantages. We believe that it is appropriate to admit three or four foreign controlled securities firms to the Chinese market and to restructure or newly establish six to seven new firms controlled or managed by Chinese professionals every year.

Harms of a Slow Opening Up

It is crucial to catch-up the gap in terms of domestic market capitalization….

The foremost harm is entirely losing the market itself. Refusal to opening up will save us a bunch of weak securities firms at the cost of losing the whole securities market. A Shanghai Stock Exchange survey shows that by the end of 2004, the aggregate floatable market capitalization of Chinese companies on overseas markets had exceeded the total market value of the two domestic stock exchanges in Shanghai and Shenzhen and the difference was expanding. While Chinese issuance on overseas markets quickened during 2005 with the recent listing of China Construction Bank and Bank of Communications, new issuance on domestic markets have come to a full stop. Equity derivatives based on Chinese stocks are being developed on both Chinese and overseas markets. We cannot help but wonder which of these derivatives will be more representative of the Chinese economy or be better risk management instruments for investment

…liquidity

into China? No doubt they are the foreign ones. Liquidity is the essence of a financial market. Once we lose it, it will be hard to recover it. It is highly urgent that we accelerate reform and opening up and improve the capabilities of securities firms and other financial intermediaries operating in the domestic market so as to keep the Chinese securities market home. When the market itself is gone, how are Chinese securities firms going to survive?

…and innovation

It has become a consensus that Chinese securities industry is short of innovation. Innovation in the Chinese market is, at best and mostly, slight adjustment of products and ideas that have been well tested in overseas markets. However, were our market be filled with first-class investment banks in the world, the innovation situation would be very different. Product innovation with regard to asset securitization is a good example. In spite of the restrictions in laws and regulations, CICC (a joint venture with Morgan Stanley) delivered the first Chinese asset securitization product (Unicom Rental Scheme), now listed on the Shanghai Stock Exchange. But even after CICC made this breakthrough, other Chinese securities firms have exhibited neither efficiency nor momentum in following its example. Why? The innovative capacity of CICC lies in its incentive and risk control mechanisms and the talents that it has attracted, of which domestic firms lack. This shows another harm of a slow opening up, namely, lagging behind the innovation frontier of international markets and the service demands of domestic companies and investors.

Conclusion

Reforms are needed otherwise China will lose the market as a whole

The Chinese experience of reform and opening up in the last twenty-seven years has shown that loosened effort of reform and opening up slow down the development of an industry. In the globalized world of today, an industry of a country that refuses to open up to competition will save the lives of a few weak players but lose the market as a whole. During his meeting with the president of ABM-AMRO in April 2004, Executive Vice Premier Huang Ju (in charge of the financial sector) pointed out that the opening up of China’s capital market should be accelerated on a timely basis and to use opening up as a spur to internal reform. It is high time that we implement his directions.

Cesare Calari

Vice-President, Financial Sector, World Bank

Reforming the Chinese Financial System: the Challenges ahead

Building on the excellent retrospective provided by the earlier session, I would like to start my remarks with a few comments which, hopefully, will help us put our discussion in perspective.

Since the liberalization that started in the late 1970s in agriculture, and in the 1980s and 90s in industry, corporate finance in China has been based on two pillars:

1) Internal cash flows have been the largest source of finance and, as prices have become more market-aligned, the only financial source of market discipline.

2) The banking system has been the second largest provider of corporate finance, but not an effective source of market discipline. In fact, bank lending has been largely used as an instrument of government policy to support money-losing industries, protect employment and to support investment in infrastructure.

Almost absent, as a source of corporate finance and discipline has been the securities markets. Indeed, to the extent it has been used at all, it has been to supplement bank financing to unprofitable public enterprises, which have traditionally accounted for the bulk of listings. It is not surprising, then, that China should be the only major Asian country, since the Asian crisis, where banking has increased its share of the financial system.

In this context, it is also not surprising that China should be the one major country where econometric work at the regional level shows that increases in bank lending to enterprises are not associated with increased productivity and GDP growth. Finally, it is not surprising that this type of non-productive lending, fueled by massive savings channeled through the banks, should have resulted in massive NPLs.

Estimating the fiscal costs of cleaning up these NPLs is admittedly more art than science. It requires making assumptions as to the recovery rate of NPLs held by the four Asset Management Companies. Thus far, net of administrative costs, these appear to have been about 10%. It also requires making adjustments to official data as supervision authorities are in the process of moving to a more forward-looking and conservative provisioning policy. Be that as it may, some analysts put the fiscal costs of cleaning up bank portfolios at over 40% of GDP in 2002.

More recently, analysts have warned about the possible build up in NPLs as a result of the credit boom in 2003-04. But even a conservative estimate would put China’s fiscal costs at an amount equivalent to roughly all the losses experienced by all other emerging markets over the past 25 years, in about 120 financial crises.

All this, and the sheer size of the country's financial system -- at 210% of GDP by far the largest among emerging countries – should give us pause and make us reflect on the systemic implications, and unique nature of the challenge faced by the Chinese Authorities. And on how the experiences of other transition economies, notably those of Central and Eastern Europe (CEE), which had very shallow financial markets and which moved aggressively with privatizations in banking and other industries, are not automatically applicable.

In particular, even leaving aside political economy considerations, issues related to bank restructuring and privatization are much more complex than those faced by the transition economies of CEE. There, sales to strategic foreign investors provided a viable solution and giving up control to foreigners of national banking systems was not a too high price to pay for the resulting stability and efficiency gains.

Would this solution be possible in China, at least for the four big banks? And would foreign investors be willing to bear the costs of recapitalizing the banks, given that they are unlikely to earn their way out of existing portfolio losses?

In this optic, the recent minority sales to strategic investors – and the announced IPOs – appear more a move to improve corporate governance and limit the influence of the Communist Party – both at the central and local levels – than a real step towards complete privatization.
One could say that, in some measure, the authorities are "outsourcing" corporate governance to foreign investors. The minority stakes invested – and the reported side deals that would make foreign investors whole in case of losses – induce to some skepticism.

In addition, in most emerging markets, partial privatizations have not worked well, and have not resulted in sustained improvements in governance and productivity. Yet, China is not "most countries", and our own experience – through IFC – with buying minority stakes in various Chinese banks, including Bank of Shanghai, has been encouraging, in terms of the improvements in governance we have been able to see. So, with all appropriate caveats, the jury is out on whether this gamble will pay off.

While much of the recent attention has been on the four large State Banks, the most interesting development may be elsewhere. Take 2nd-tier banks, for example. They have been gaining market share from the Big Four (roughly 34%), they are not plagued with the same magnitude of NPLs, and they are well positioned to lend to SMEs and to the growing consumer and mortgage market. When not already private, their size makes them more manageable for privatization. Indeed, there are currently 17 second-tier banks with foreign investors, in addition to the proposed acquisition of Guangdong Development Bank (85%) by Citigroup and Carlyle (a landmark event, if it goes through).

Take the various pilots to reform the 37,000 Rural Credit Cooperatives (RCCs), which hopefully could result in introducing some innovation and competition in the highly rigid monopolistic and inefficient rural financial markets.

The proposed reform of the Postal Savings System (State Council, July 2005) should result in the establishment of an independent Postal Savings Bank with close to 10% of total banking deposits and a capillary presence throughout the country. This infrastructure could provide the platform for a nationwide microfinance bank – *à la* BRI in Indonesia – which could successfully compete with the RCC in rural areas and bring some needed regional balance to financial development.

Possibly most exciting, though, is the fast growth of consumer and mortgage finance – from virtually nil in 1998, to roughly 10% of bank credit today. Of this, mortgage finance is the largest component, and indeed its growth has been astonishing. With mortgages equivalent to 13% of GDP, China has, after Chile, the second largest mortgage market among emerging nations.

Given remaining uncertainties about property rights, and the scarcity of good credit information, this is not without risks, and indeed there are signs of speculative behaviors in certain areas, such as Shanghai. But the legal infrastructure is catching up, and the rapid progress in creating a nation-wide system of credit bureaus should improve the information base.

Short of privatizing land, I cannot think of anything that could change Chinese society more than home ownership. Mortgage finance is also a powerful instrument to rebalance economic growth trends a more consumption-driven model.

Finally, there have been important recent regulatory changes to improve the transparency and liquidity of securities markets, including the New Securities Law of October 2005. By and large, these should result in better disclosure and investor protection, although I continue to have some questions about the new Securities Investor Protection Fund. If the latter were used to bail out investors of trading losses – as opposed to protecting them against broker defaults – then it could introduce perverse incentives and reckless behaviors which could be harmful to the market.

On balance, though, combined with new net capital rules for securities firms, with new criteria for Qualified Foreign Institutional Investors, and with a reform of the A-share market, the new reforms should go same way towards revitalizing the capital markets. Hopefully, these will be followed by steps to streamline the bond markets, including better integration between exchange-traded bonds and the Interbank Bond Market, which should result in better liquidity.

Also, the regulatory approach should move to a disclosure system and away from an approval system which could create a sense of false security among the investors and carry the seeds of future government bailouts.

In conclusion, financial reforms in China are overall headed in the right direction. WTO accession presents obvious risks given the operational and financial weaknesses which still plague state-owned banks.
These weaknesses will likely result in major fiscal liabilities for the Government, but these should be manageable, barring catastrophic events in the global economy or domestic socio-political developments which could trigger massive government spending.

The outcome of governance reforms in the larger state banks is unclear at this point, and caution is in order. Nevertheless, competitive pressures from foreign investment and from the diversification of the financial system – through second-tier banks and more active mortgage and securities markets – should result in greater efficiency in the financial system.

Improvements in regulatory quality and capacity, in both banking and securities markets, are also encouraging, although the challenges of developing the required human capital remain daunting. An even greater challenge is represented by the need to develop a credit culture, starting with building up the risk-management capabilities of banking institutions.

I should add that my considerations are based on technical factors, which cannot, however, ignore the country's complex political economy and social evolution. This is the great unknown and the great risk factor which ultimately will determine the path and the success of financial reform.

The PB Index

Performance Analysis

Overview

The PB Index tracks the performance of shares of privatized companies that are listed for trading in domestic stock markets of the enlarged European Union.

The PB Index is capitalization weighted, and denominated in Euro. It is restricted to ordinary shares of privatized companies trading in the stock exchanges of the European Union, including the ten new accession countries.

It is subject to a quarterly review by the PB Index Administrator, who ensures the overall consistency with the purposes of the Index. Index maintenance implements the adjustment for company additions and deletions and stock price adjustments due to corporate actions (including dividends) and merger and acquisition (M&A) activity.

The PB Index maintenance rules try to take into account for M&A operations which may affect the risk and return profile of privatized companies. Particularly, the privatized company's share price is replaced by the one of the acquiror *(a)* if the acquiror is a European company listed in a stock market of the enlarged European Union and *(b)* if the acquiror's market capitalization is not more than double of the one of the target. The first condition avoids to include in the PB Index non European stocks exposed to different systemic risk. The second is based on the assumption that in case of M&A the idiosyncratic factors affecting privatized companies spill over only if the private acquiring company is comparable in size.

Following these rules, a Composite Index, two regional sub-indexes (one including EU15 and one the ten new accession countries) are constructed, together with five sector sub-indexes (Banking, Industrial, Oil & Gas, Utilities, and Telecom).

As of June 2006, the PB Composite Index includes 251 stocks. The two regional indexes include 182 companies of EU15 countries and 69 companies of the ten new accession countries of Eastern Europe. The five sector sub-indexes Banking, Industrial, Oil & Gas, Telecom and Utilities, include 37, 37, 13, 25, and 46 stocks, respectively (see Table 1). This new release of the PB Index features 17 new stocks, due to six IPOs and 11 additions thanks to newly available data.

A more detailed description of the PB Index can be found in the Rulebook (available at www.privatizationbarometer.net/site/rulebook.pdf).

Analysis

In this section, we briefly describe the return and risk characteristics of privatized companies over the short and the medium run, up to three years.

Figure 1 refers to the PB Composite Index, which includes the whole set of privatized companies for which we track the performance. The figure shows that, had one invested €100 mil in this index in June 2003, after three years the investment would be worth €171 mil. The cumulative return of the PB Composite is now as high as 68.6 percent (Table 2).

The time span under study is particularly interesting because it allows to track the performance of PB Indexes during a period of marked downside such as Q2.

Overall, the two broader indexes, namely the PB Composite and the PB Old Europe have outperformed the (European) Dow Jones STOXX Total Market Index (TMI), that we use as benchmark. More particularly, privatized companies appear extremely valuable as defensive stocks in times of market correction. Over the last quarter, these two indexes yielded excess returns of 7.1 and 7.6 percent, respectively, thus reacting less negatively than the market to a change in economic fundamentals. On a two and three years basis, the PB Composite gained (annualized) excess returns of 3 and 3.6 percent, while it slightly underperformed the benchmark during the last year. Not surprisingly, the PB Old Europe follow closely the Composite (Table 3).

In previous analyses, we pointed out a similar behavior of the PB New Europe and its benchmark (i.e. the Dow Jones EU Enlarged TMI) and tentatively explained it in terms a high fraction of overlapping capitalization between these two indexes. Surprisingly, we find some negative excess returns in the PB New Europe, especially over the year.

Several PB sector indexes have been severely hit by the recent market downturn. Yet we confirm the strong overperformance of PB Banking Index observed in previous analysis. Privatized banks gained a stellar 15.2 percent on a yearly basis relative to the Dow Jones STOXX Banking. Drivers of this strong performance have been Portuguese banks such as BANIF and Banco BPI, and some large Italian financial firms such as Monte dei Paschi and Capitalia. Indeed, the regulatory environment in Italy after the appointment of the new Governor should foster M&A activity in the financial sectors, pushing valuation of some perspective targets (Table 3).

We also report some overperformance of the PB Utilities Index, which yielded excess returns of 2.6 percent on a yearly basis. A significant part of this gain is attributable to the strong gains of British Energy Group, the UK based nuclear power generator. The company, which underwent a strong restructuring process and was relisted in the London Stock Exchange, gained a stellar 74 percent over the last year. Drivers of the high reported gains in the electricity sectors have been the controversial take-over bids launched on the Spanish Endesa and the French Suez, which gained 43 and 38 percent on a yearly basis, respectively.

In what follows, we briefly analyze the risk-adjusted performance yielded by our PB Indexes by use of the conventional Sharpe ratio, given by the differential return of our index relative to a risk-free investment (namely, the 3-month Euro Interbank Offered Rate) divided by the standard deviation of the differential return. The Sharpe ratio has also been computed for our benchmarks, in order to gauge the differential risk-adjusted performance. We have also computed the Information ratio, given by the differential return relative to its benchmark divided by the so called tracking-error volatility (i.e. the standard deviation of the excess returns). While the Sharpe ratio provides a measure of return per unit of total risk, the Information ratio provides a measure of active risk and hence of relative risk-adjusted performance.

We calculate these ratios for the three-year period, which is the conventional time-horizon used by asset managers and investment consultants.

In line with previous results, privatization companies performed well also after controlling for price volatility. Over the 36-month period, all the PB Indexes - with the only exception of the PB New Europe - show higher Sharpe ratios with respect to all benchmarks. The more pronounced differences are found for the PB Composite, for the PB Old Europe and PB Banking (Table 7).

The analysis of the Information ratio confirms the strong relative risk-adjusted performance for a highly diversified portfolio of privatized firms. The Information ratio of the PB Composite Index is 0.77, indicating approximately 90 basis points of out performance relative to the benchmark Dow Jones STOXX TMI for every 120 basis points of (active) risk (Table 8). The PB Old Europe and especially Banking indexes report yields on the information ratios, 0.71 and 1.77, respectively.

As customarily, we have estimated a conventional Capital Asset Pricing Model (CAPM), where excess returns over the risk free asset are regressed against a market risk factor and sector excess returns. The PB Composite, Old Europe, Banking and Industrial Index regressions yield intercepts which are statistically different from zero. These intercepts are the conventional *Jensen's alpha*, a widely used measure of over performance over large and broadly diversified portfolios. Our most conservative estimates based on daily data yield an alpha of 1.6 basis points for the PB Composite (Table 9). A back of the envelope calculation suggests that a passive investment in a fund based on the PB Composite index gained approximately 4.1 percent excess returns on an annual basis with respect to a broadly diversified portfolio. Indeed, the most recent results confirms our previous analyses. Privatized companies represent appealing investing opportunities even under difficult market conditions.

Table 1. PB Indexes Constituents (as of 06/15/2006)

PB Indexes	# of Constituents	Old Europe	% Old Europe	New Europe	% New Europe
Composite	251	182	72.51%	69	27.49%
Banking	37	29	78.38%	8	21.62%
Industrial	37	33	89.19%	4	10.81%
Oil & Gas	13	9	69.23%	4	30.77%
Telecom	25	18	72.00%	7	28.00%
Utilities	46	40	86.96%	6	13.04%

Source: Elaborations on *Datastream.*

Table 2. PB Indexes Returns

PB Indexes	Value as of 06/15/2006	3 Months	1 Year	2 Years	3 Years
Composite	171.348	-4.875%	10.238%	37.760%	68.603%
Old EU	170.107	-4.745%	11.745%	37.794%	67.274%
New EU	214.456	-12.694%	8.155%	65.591%	115.577%
Banking	204.112	-8.609%	31.387%	64.651%	99.318%
Industrial	190.790	-9.214%	12.557%	39.085%	87.354%
Oil & Gas	151.818	-8.494%	0.129%	25.484%	45.845%
Telecom	115.701	-8.580%	-10.820%	2.617%	18.512%
Utilities	181.481	-6.237%	20.242%	54.775%	80.303%

Note: The base date is the 06/02/2003. Return indicates the cumulative % increase/decrease of the index.
Source: Elaborations on *Datastream.*

Table 3. PB Indexes Average Excess Returns

PB Indexes	Benchmarks	3 Months	1 Year	2 Years	3 Years
Composite	DJ Stoxx TMI	7.168%	-2.618%	3.046%	3.656%
Old EU	DJ Stoxx TMI	7.615%	-1.105%	3.060%	3.340%
New EU	DJ Stoxx EU Enlgd TMI	-2.356%	-6.713%	-2.530%	-2.233%
Banking	DJ Stoxx Banking	-0.474%	15.286%	12.858%	11.025%
Industrial	DJ Stoxx Indl Goods&Serv	-2.873%	-6.703%	-1.547%	2.327%
Oil & Gas	DJ Stoxx Oil & Gas	-8.629%	-5.777%	-2.596%	-0.780%
Telecom	DJ Stoxx Telecom	-4.434%	-5.485%	-0.854%	-0.186%
Utilities	DJ Stoxx Utilities	0.888%	2.166%	1.533%	-0.229%

Note: The base date is the 06/02/2003. Average excess return indicates the historic average differential return of the index to its respective benchmark. All values are annualized.
Source: Elaborations on *Datastream.*

Figure 1. Performance of the PB Indexes

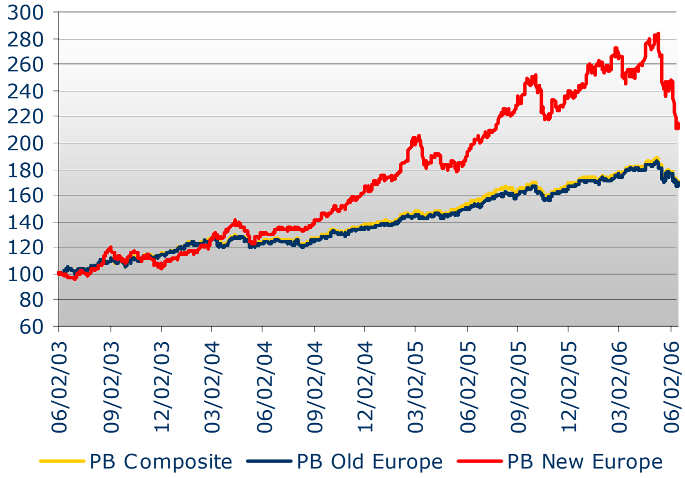


Figure 4. Cumulative Excess Returns of the PB Indexes

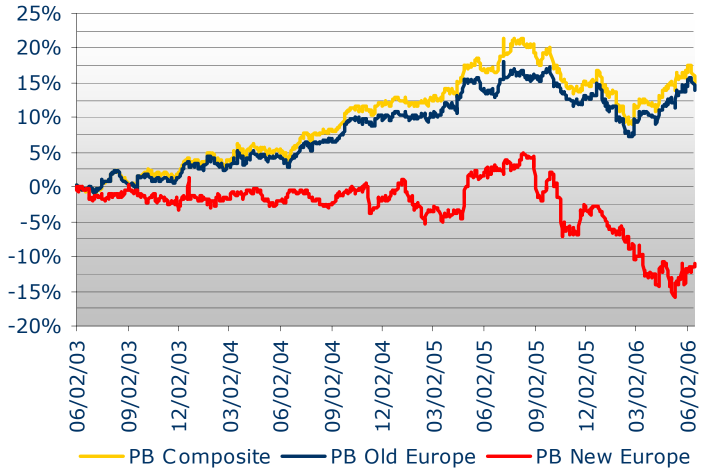


Figure 2. Performance of the PB Indexes

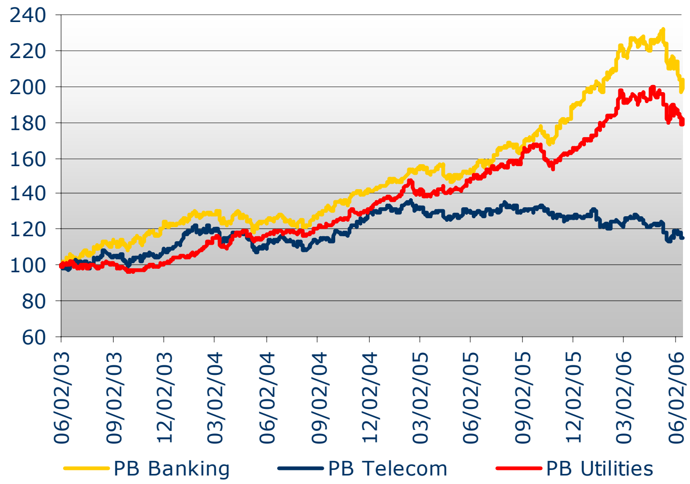


Figure 5. Cumulative Excess Returns of the PB Indexes

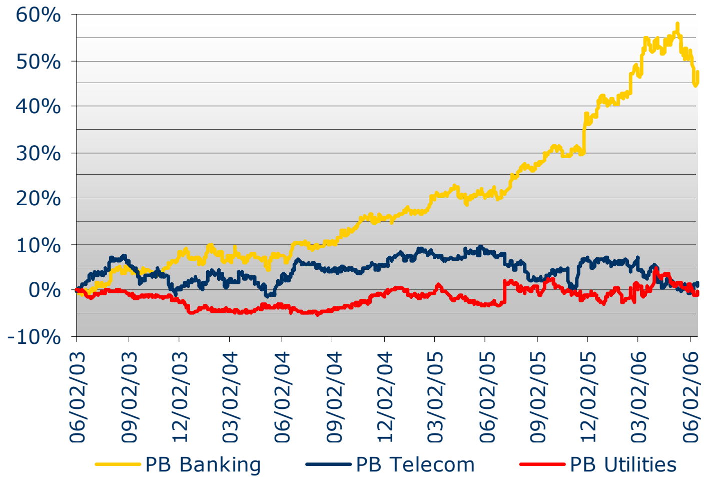


Figure 3. Performance of the PB Indexes

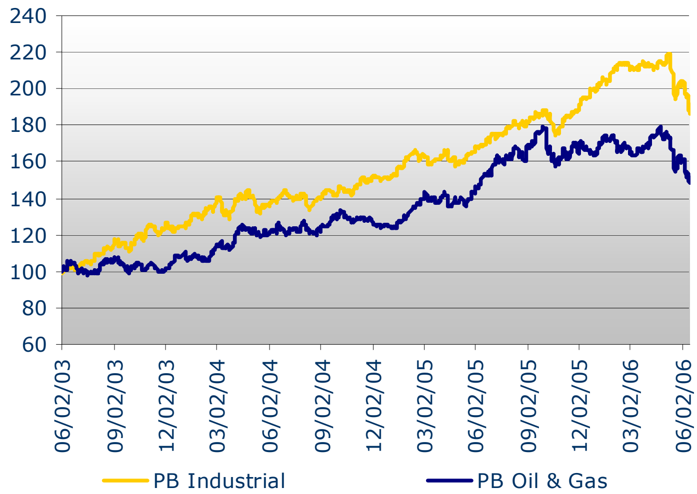


Figure 6. Cumulative Excess Returns of the PB Indexes

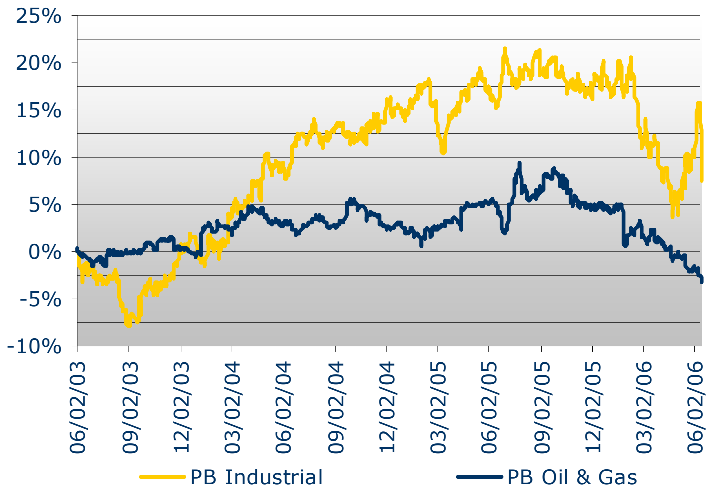


Table 4. PB Index TOP & WORST 10 Performers

OLD EUROPE

	TOP 10 Performers					WORST 10 Performers			
	Company	**Nation**	**Value as of 06/15/06**	**1 Year Change (%)**		**Company**	**Nation**	**Value as of 06/15/06**	**1 Year Change (%)**
1	BANIF	Portugal	22.20	218.97%	**1**	Alitalia	Italy	0.80	-58.71%
2	SALZGITTER	Germany	60.15	184.80%	**2**	Thomson	France	13.36	-35.46%
3	Arcelor	France	33.53	109.56%	**3**	Kingston Comm. Hull	UK	0.74	-28.16%
4	SSAB	Sweden	40.84	108.26%	**4**	Cable & Wireless	UK	1.61	-27.48%
5	Banco BPI	Portugal	5.81	86.82%	**5**	TDC	Denmark	25.49	-27.30%
6	Rautaruukki	Finland	21.06	77.87%	**6**	Acegas	Italy	6.70	-26.54%
7	Corus Group	UK	5.61	76.97%	**7**	Bull	France	5.00	-26.47%
8	BRITISH ENERGY GROUP	UK	9.69	74.91%	**8**	France Telecom	France	17.09	-23.71%
9	Ass.British Ports Hldgs	UK	12.77	72.33%	**9**	Havas	France	3.71	-22.38%
10	Voestalpine AG	Austria	96.29	71.33%	**10**	Hellenic Sugar Industry	Greece	2.75	-21.43%

NEW EUROPE

	TOP 10 Performers					WORST 10 Performers			
	Company	**Nation**	**Value as of 06/15/06**	**1 Year Change (%)**		**Company**	**Nation**	**Value as of 06/15/06**	**1 Year Change (%)**
1	Kopex	Poland	42.77	269.66%	**1**	Krosno	Poland	1.52	-42.21%
2	IMPEXMETAL	Poland	27.61	167.54%	**2**	OTP BANK	Hungary	20.33	-25.20%
3	KGHM	Poland	20.34	152.67%	**3**	Philip Morris CR	Czech Rep.	435.65	-24.83%
4	MOSTOSTAL WARSZAWA	Poland	3.87	144.94%	**4**	TVK	Hungary	18.68	-19.93%
5	ELEKTROBUDOWA	Poland	12.28	116.96%	**5**	Borsodchem	Hungary	8.13	-14.15%
6	MOSTOSTAL - EXPORT	Poland	0.54	107.69%	**6**	Polmos Bialystok	Poland	16.86	-14.07%
7	Rafako	Poland	6.01	98.35%	**7**	Raba	Hungary	2.52	-13.99%
8	Zelmer	Poland	8.70	92.90%	**8**	MATAV	Hungary	2.95	-11.14%
9	Krka	Slovenia	609.29	87.23%	**9**	Bedzin	Poland	6.29	-10.01%
10	Bytom	Poland	5.79	84.98%	**10**	Grupa Zywiec	Poland	111.42	-9.58%

Source: Elaborations on *Datastream.*

Table 5. PB Index Old Europe Sectorial Top Performers

		Company	Nation	Value as of 06/15/2006	1 Year Change (%)
Banking	**1**	BANIF	Portugal	22.20	218.97%
	2	Banco BPI	Portugal	5.81	86.82%
	3	DVB Bank	Germany	185.50	62.53%
Industrial	**1**	Associated British Ports Hldgs	United Kingdom	12.77	72.33%
	2	AEA Technology	United Kingdom	1.61	56.31%
	3	BAA	United Kingdom	13.61	48.74%
Oil & Gas	**1**	Saipem	Italy	17.02	56.29%
	2	British Gas	United Kingdom	9.64	47.63%
	3	Neste Oil	Finland	24.84	27.45%
Telecom	**1**	KPN	Netherlands	8.91	36.87%
	2	Eircom Group	Ireland	2.16	30.12%
	3	Sirti	Italy	2.06	18.77%
Utilities	**1**	BRITISH ENERGY GROUP	United Kingdom	9.69	74.91%
	2	Verbund	Austria	33.69	58.69%
	3	Fortum	Finland	18.66	54.21%

Table 6. PB Index Old Europe Sectorial Worst Performers

		Company	Nation	Value as of 06/15/2006	1 Year Change (%)
Banking	**1**	Dexia	Belgium	18.030	-0.50%
	2	DEPFA	Germany	12.560	-5.63%
	3	Mediobanca	Italy	15.100	-2.45%
Industrial	**1**	Thales	France	28.880	-16.17%
	2	Eniro	Sweden	8.000	-16.05%
	3	EADS	France	20.000	-14.16%
Oil & Gas	**1**	Repsol	Spain	20.720	0.24%
	2	British Petroleum	United Kingdom	8.790	1.97%
	3	Total	France	48.440	3.11%
Telecom	**1**	Kingston Communications Hull	United Kingdom	0.740	-28.16%
	2	Cable & Wireless	United Kingdom	1.610	-27.48%
	3	TDC	Denmark	25.490	-27.30%
Utilities	**1**	Acegas	Italy	6.700	-26.54%
	2	ACSM	Italy	2.120	-16.86%
	3	Public Power Corp	Greece	18.820	-5.62%

Source: Elaborations on *Datastream.*

Table 7. PB Indexes Sharpe Ratios

Indexes	PB Index	Benchmark	PB Index	Benchmark	PB Index	Benchmark
	1 Year		*2 Years*		*3 Years*	
Composite	0.668	0.839	1.445	1.087	1.466	1.091
Old EU	0.791	0.839	1.433	1.087	1.423	1.091
New EU	0.261	0.599	1.397	1.621	1.480	1.690
Banking	1.897	1.032	1.984	1.107	1.710	0.969
Industrial	0.789	1.083	1.335	1.302	1.599	1.348
Oil & Gas	-0.122	0.183	0.584	0.746	0.669	0.716
Telecom	-1.067	-0.527	-0.096	-0.022	0.257	0.249
Utilities	1.353	1.192	1.934	1.741	1.716	1.643

Note: Sharpe Ratio indicates the historic average differential return of the index over a risk-free asset (Euribor Interbank Offered Rate 3m) per unit of historic variability of the differential return.
Source: Elaborations on *Datastream*.

Table 8. PB Indexes Information Ratios

PB Indexes	1 Year	2 Years	3 Years
Composite	-0.494	0.640	0.779
Old EU	-0.212	0.649	0.716
New EU	-1.406	-0.554	-0.423
Banking	2.193	2.134	1.762
Industrial	-0.853	-0.226	0.327
Oil & Gas	-1.354	-0.688	-0.204
Telecom	-0.719	-0.130	-0.026
Utilities	0.434	0.368	-0.057

Note: Information Ratio indicates the historic average differential return of the index to its respective benchmark per unit of historic variability of the differential return.
Source: Elaborations on *Datastream*.

Table 9. PB Indexes Jensen Alphas

PB Indexes	Jensen α	β	R-squared
Composite	0.0002%	0.875	84.99%
	(1.81)	(66.54)	
Composite*	0.0165%	0.529	86.54%
	(1.76)	(6.40)	
Old EU	0.0002%	0.887	85.27%
	(1.66)	(67.28)	
Old EU*	0.0002%	0.526	87.12%
	(1.63)	(6.43)	
New EU	-0.0001%	1.010	91.57%
	-(0.57)	(92.16)	
Banking	0.0004%	0.945	79.73%
	(2.67)	(55.47)	
Industrial	0.0002%	0.810	74.07%
	(1.24)	(47.28)	
Oil & Gas	0.0000%	0.972	94.79%
	-(0.16)	(119.25)	
Telecom	0.0030%	0.799	75.54%
	(0.20)	(49.15)	
Utilities	0.0071%	0.895	88.78%
	(0.84)	(78.68)	

* Market sectorial controls included.
Source: Elaborations on *Datastream*.

Selected News

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DENMARK

2006-04-18- **DONG Owners To Review Decision To List 28% Of Energy Company**

COPENHAGEN (Dow Jones)--A decision to list 28% of **DONG A/S** isn't set in stone, and will be reviewed as the Danish energy giant's owners - the Danish state and nine local power companies - prepare for its initial public offering in 2007, a government official said. In an interview, Peter Brixen, head of the Finance Ministry's division for state-owned companies, said, "The actual size will be determined as a part of the preparation for the sale." According to Danish analysts, investors will likely demand a 10-15% discount for DONG shares, because of the relatively low level of free float they expect. DONG is valued at around 60 to 64 billion kroner. The partial listing, originally aimed for 2006, follows a DONG-led consolidation of the Danish energy sector. Starting in 2004, the oil and gas company began acquiring power companies, including Denmark's two largest. In March, the E.U. Commission approved the acquisitions. Wednesday, DONG will increase its share capital to complete a share swap with the nine power companies that originally held stakes in the companies that DONG acquired. After the deal, the Danish government will hold a 73% stake in DONG while the nine companies will hold the remaining 27%. The size of their stakes vary from 0.1% to 7.2%, held by SEAS Transmission A/S. DONG embarked on its takeover spree with the blessing of the government, which sought to keep ownership of Danish power assets in Denmark and to build a company large enough to compete against neighboring rivals such as Sweden's state-owned Vattenfall Group.

FRANCE

2006-06-07 - **France Telecom to sell stake in Pages Jaunes**

PARIS - France Telecom is preparing to sell part or all of its majority holding in directory business **Pages Jaunes** as it no longer considered it necessary for its strategy. "The board of directors of France Telecom approved the group's management proposal to prepare a partial or full divestiture of France Telecom's stake in Pages Jaunes, "it said in a statement. As recently as last month, France Telecom denied it was considering the disposal of its 54 percent stake, a move which at current market prices could raise more than 3 billion euros ($3.85 billion). "This raises questions about what they will do with the cash in the future," said Jonathan Dann, analyst at Bear Stearns in London. "We would prefer to see a buy-back of the stock." France Telecom is struggling to respond to cut-throat competition from smaller and more nimble fixed and mobile operators in its home market and abroad. It recently launched a series of new services and rebranded its main operations under the Orange mobile banner in an attempt to revitalise sales and compensate for the progressive shrinking of its traditional fixed-line voice business. Pages Jaunes, France's leading publisher of printed and online directories was spun out of France Telecom in 2004.

GERMANY

2006-04-07 - **German Parliament Votes To Privatize Air-traffic Control**

BERLIN (AP)--German lawmakers approved government plans to privatize the country's air-traffic control agency, a move designed to attract investment and improve efficiency. The bill allowing the sale of up to 74.9% of **Deutsche Flugsicherung**, the national air-traffic control company, passed by large majority. The government plans to retain at least 24.9% of the shares. The planned sale will allow Germany to meet European Union requirements to limit the role of governments to that of a regulator. The government says the move won't lead to any decline in safety standards, though some opposition politicians say it is against the German constitution. The government plans to establish a Federal Office for Air-Traffic Control to act as regulator and issue licenses to air-traffic control companies.

2006-06-18 - **GERMAN PRESS: Minister Sees Deutsche Bahn IPO In 2008**

FRANKFURT (Dow Jones)--German railway operator **Deutsche Bahn AG** could see its initial public offering in 2008, German Minister for Transportation, Construction, and Housing, Wolfgang Tiefensee, told weekly magazine Focus. According to an advance copy of an interview to be published in Monday's magazine, Tiefensee said, "we should work the switches quickly and thoroughly this fall," for an IPO as early as 2008. "If (the German) parliament creates the necessary framework and the Deutsche Bahn AG shows it is ready for the capital market, then an IPO is possible starting in 2008," Tiefensee told the magazine. Tiefensee said the government hasn't decided yet whether Deutsche Bahn should go public with ownership over its track network or has to sell the network before going public. In a previous announcement given on January, 2006 the company affirmed its intention to place initially between 25% and 30% of its shares on the stock market However, the company would also consider a trade sale, as it is assumed to be interesting for financial investors. Moreover, Deutsche Bahn management intends to take the company public in its current form, including the railway grid, rather than separating the train operations from the grid operations. In recent months, critics have warned that privatizing the company, including the railway network, would require the government to participate in any possible capital increase. However, Sack insisted a capital increase was neither planned nor required to take the company public.

GREECE

2006-01-09 - **Privatizations Among Greece's Top 2006 Economic Priorities**

ATHENS (Dow Jones)--Privatization of a number of state controlled companies is among the Greek government's top economic objectives for 2006, Finance Minister George Alogoskoufis said.

"The listing of the Postal Savings Bank and a placement of **Agricultural Bank of Greece**," are among planned privatizations Alogoskoufis reiterated, as is "the further privatization of **Emporiki Bank**, in collaboration with the French." France's Credit Agricole currently has a stake of around 9.1% in Emporiki and is seen as Greece's preferred buyer for part or all of its 41% stake.

2006-02-22 - **Greek Government To Part-Privatize Gas Supplier, Sell Agricultural Bank of Greece**

ATHENS (AP)--Greece's Finance Ministry said it will sell part of the country's natural gas supplier by listing it on the Athens Stock Exchange. The state will also go ahead with eventual privatization of the **Agricultural Bank of Greece SA**, in which it holds an 85% stake. The ministry didn't say how much of the natural gas supplier, **DEPA**, it would offer to list or when it would do it. The state owns a 65% stake in DEPA. It also said it would speed up the privatization of **Emporiki Bank of Greece SA**, essentially expressing its willingness to sell the state's entire 41% stake - 9% directly and 32% through state pension funds. Credit Agricole SA has already a 9% stake in Emporiki.

2006-02-28 - **Greece Aims To Raise EUR1.65B From Privatizations In 2006**

ATHENS (Dow Jones)--Greece is aiming to raise EUR1.65 billion from privatizations in 2006 as part of efforts to cut the country's budget deficit and to increase private investment in the economy, the government's privatization committee said Tuesday. The committee, comprised of the prime minister as well as the ministers of finance, development and labor, gave its formal list of companies slated for privatization in 2006. Within the first half this year Greece is looking to sell stakes via placements in **Emporiki Bank**, **Agricultural Bank of Greece** and the **Postal Savings Bank**. Greece currently has a total indirect and direct 41% stake in Emporiki Bank and an 85% stake in Agricultural Bank. The committee said Greece has also started the process for the listing of natural gas supplier **Depa**, but didn't say when the listing will take place or how much of the company will be offered. In 2005, Greece raised EUR2.1 billion from privatizations compared with the 2005 budget's target of EUR1.6 billion. Greece's budget deficit was 4.3% of gross domestic product in 2005. The 2006 budget targets a deficit of 2.6% of GDP.

2006-03-21 - **Athens Airport And Piraeus Port To Create Cargo Link**

ATHENS (Dow Jones)-- Greece is looking to sell part of its stakes in both Athens Airport and Piraeus Port in 2007.

IRELAND

2006-04-04 - **Irish Minister: Aer Lingus IPO To Happen "As Soon As Possible"**

DUBLIN (Dow Jones)--Ireland's Minister for Transport Martin Cullen said Tuesday that corporate advisers have been appointed to handle the stockmarket flotation of state carrier **Aer Lingus** "as soon as possible." "Work on the sale process will commence immediately," Cullen said. The government will retain a minimum 25.1% stake in Aer Lingus to protect the state's strategic interests, while allowing the state to also manage the airline's commercial needs, Cullen added. Cullen didn't give an exact timeline for the IPO, but added: "The government's corporate advisers have been instructed to complete the sale transaction as soon as possible, taking account of exchange regulations and market conditions." Analysts see the government selling off around 60% of Aer Lingus -currently valued at around EUR700 million -by September 2006 at the very latest, which will leave staff with a stake of around 15%. However, Jack O'Connor, general secretary of the Services, Industrial, Professional & Technical Union, SIPTU, said that no assurances had been given on jobs, outsourcing or the current pension deficit at the airline. Transport Minister Cullen also said he is open to an "upfront investment" from the sale proceeds and increased contributions by both the company and its employees. The unions however, remain opposed to a hike in staff pension contributions. SIPTU represents 2,200 of the airline's 3,475 staff; the government now owns 85.1% of the carrier, with the rest held by staff.

2006-06-14 - **Schiphol CFO: Sees IPO In October Or November**

AMSTERDAM (Dow Jones)--Dutch airport operator **Schiphol Group** expects an October or November public listing of part of its share capital on the Euronext Amsterdam Exchange, Chief Financial Officer Pieter Verboom said. Speaking on the sidelines of a Dutch CFOs conference in the city of Noordwijkerhout, Verboom said an IPO sometime in those months "should be achievable," despite pressure from several interest groups trying to prevent the listing, or at least influence the specifics of it. The Dutch government is planning to sell a minority stake in Schiphol Group through a combined initial public offering and private placement. The government plans to list part of that minority stake publicly, and to sell part to institutional investors with a lockup period. A possible listing for Schiphol has been an issue regularly debated during the past decade, with all sorts of lobby groups and political parties involved. Environmentalists are trying to block further airport expansion and left-wing political parties aim to prevent privatization of what they consider an asset that should remain in public hands. The Dutch government hopes to reel in serious money from its stake disposal. The city of Amsterdam, a main shareholder in the airport, opposes an IPO. The Dutch government holds a 75.8% stake in the national airport, the city of Rotterdam has a 2.4% stake, and the city of Amsterdam, which is dominated by left-wing political parties and which harbors Schiphol, has a 21.8% stake.

PORTUGAL

2006-02-16 - **Portugal Eyes EUR2.4B In Privatizations Through 07**

LISBON (Dow Jones)--The Portuguese government expects to raise EUR2.4 billion from the sale of state-held assets through 2007, said Finance Minister Fernando Teixeira dos Santos. Teixeira dos Santos spoke following the weekly cabinet ministers meeting that set out a timetable for the sale of partial stakes in a number of companies. For 2006, the government expects to sell up to 20% of energy group **GalpEnergia SGPS**, via an initial public offering, and all of its 25.7% stake in pulpmaker **Portucel SGPS**. It also plans to sell all of its stake in papermaker **Inapa** either this year or next, and will reduce its 25.5% stake in **Energias de Portugal SA** (**EDP**) and its 100% stake in grid operator **REN SA** in 2006 or 2007. A partial privatization of wholly-owned flag carrier **TAP-Air Portugal** is also on the cards for 2007, as well the privatization of airport operator **ANA**. Teixeira dos Santos said the state expects to raise EUR1.6 billion from asset sales in 2006 and EUR800 million in 2007. It also forecasts EUR700 million in revenue for 2008 and EUR600 million for 2009, although any asset sales planned for those years haven't yet been specified.

THE NETHERLANDS

2006-01-26 - **Dutch Finance Minister Wants To Proceed With Sale Of Connexxion**

THE HAGUE, Netherlands (Dow Jones)--The Dutch Finance Minister reiterated he sees no obstacles to privatizing national bus company **Connexxion** and brushed aside management concerns over the timing of a sale. "In principle, there's no reason to keep the 100% stake as the market in which Connexxion operates is already liberalized," said Gerrit Zalm, speaking at a parliamentary hearing on state participation in companies. Zalm said he was in talks with Connexxion's management which favors a more gradual privatization with the government bringing down its stake step by step. Connexxion director Peter Kortenhorst said earlier he wasn't sure whether the privatization would go ahead in 2006. He added he would prefer it if the company wasn't sold to one firm. Zalm said the company's financial position and corporate governance structure wouldn't hinder privatization. The government owns 100% of Connexxion. Connexxion has a 62% share of the Dutch bus market.

2006-02-09 - **Dutch Planning To Sell State-Owned Publisher SDU**

LONDON (Dow Jones)--The Dutch government is to begin the process of selling all or part of its 100% stake in Dutch publisher **SDU NV**, which publishes government-related items. SDU could fetch as much as EUR450 million, and is expected to interest both trade and financial buyers. The sale is expected to kick off sometime during the current quarter. Fortis Bank N.V. is advising on the sale of SDU. The planned sale of SDU is the latest in a growing wave of Dutch privatizations, driven in part by budgetary pressures. In January, the Dutch Finance Ministry said it sees no obstacles to privatizing Connexxion, the national bus operator.

2006-06-14 - **Schiphol CFO: Sees IPO In October Or November**

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UNITED KINGDOM

2006-02-12 - **UK Rail Operator Mulling Re-Privatization**

LONDON (Dow Jones)--U.K. railways operator Network Rail is examining a "re-privatization" scheme, the Sunday Times reports, citing a document published by rail regulator the Office of Rail Regulation. The newspaper says **Network Rail**, which was set up by the U.K. government to take over the railways after the collapse of Railtrack in 2001, is seeking to raise finance outside government indemnity. A spokesman for Network Rail said: "This is something we are looking at." He added that no advisers had been appointed.

2006-03-20 - **UK PRESS: Government May Sell Scottish Water For GBP2B**

LONDON (Dow Jones)--The U.K. government wants to privatize **Scottish Water** in a flotation that would raise more than GBP 2 billion for the public purse but could cause a political storm in Scotland, according to The Telegraph. Scottish Water has been tipped as a prime privatization candidate by insiders at the U.K. Treasury. It is the U.K.'s largest water authority still in public ownership and has undergone stringent cost-cutting in the past four years, the newspaper writes.

2006-03-23 - **UK PRESS: UK Government Mulls Urenco, British Nuclear Fuels Sale**

LONDON (Dow Jones)--The U.K. government plans to divest a wide range of publicly owned energy assets including its stake in uranium enrichment company, **Urenco**, the Daily Telegraph reported. The paper said it was understood that the government would seek to exit its one third stake in Urenco, valued at GBP2.5 billion, by floating the company on the London Stock Exchange. The U.K. government owns its one third stake in Urenco via the **British Nuclear Fuels**, another company which the Telegraph said the government will sell.

CZECH REPUBLIC

2006-03-16 - **Czech Government Postpones Aero Vodochody Jet Maker Sale**

PRAGUE (Dow Jones)--The Czech government has put off the sale of state-owned subsonic jet maker **Aero Vodochody**, saying it needs more time to evaluate the transaction, said Cabinet spokeswoman Lucie Orgonikova. The sale of the company, which also operates an airfield near Prague, has attracted bids from six domestic private equity companies. Some of the potential bidders have said they would like to convert Aero Vodochody's airfield into a civilian airport. Orgonikova said the government had decided to analyze any potential impact the conversion of Aero Vodochody's airfield might have on the air traffic in the Czech capital. Government officials have also said any new owner of the jet maker should maintain its aircraft production. Aero Vodochody manufactures L-159 subsonic trainer jets, so far purchased only by the Czech Army, services its older aircraft and carries out subcontract work for other aircraft makers, including Boeing Co. However, with the Czech Army the only buyer of its flagship L-159, Aero Vodochody has struggled in recent years. The privatization will be resumed July 17, after the study is complete and June parliamentary elections, Orgonikova said. The government previously tried to pair the company with Boeing, but the partnership collapsed in 2005 and the U.S. company returned its stake to the Czech state. The government is now selling its 99.97% of the jet maker and a package of its debt claims against the company, totaling 9 billion koruna.

HUNGARY

20006-06-16 - **Hungary Seeks Adviser To MOL Stake Sale By End '06**

BUDAPEST (Dow Jones)--The Hungarian government invited a one-round invitation-only tender to find a privatization adviser on the sale of its remaining stake in Hungarian oil and gas company **MOL Magyar Olaj- es Gazipari Rt**. The government holds 1,893,476 MOL shares, or a 1.76% stake, which is worth about 36.45 billion forints ($169.5 million) at current market value of HUF19,250 a share. Hungary's state privatization agency APV Rt. is seeking the adviser to advise and manage the sale, APV said in paid advertisement in several daily papers. It's unclear what way the upcoming privatization will be carried out, based on the announcement. It could take place in one or several stages, with the first stage a public offer to domestic retail investors, the APV said. But the sale could also take the form of a stock exchange transaction, prior to or replacing the public offer, the APV added. The sale will come maybe in the autumn but surely by the end of this year, political daily Nepszabadsag quoted APV Spokesman Peter Oravecz.

2006-05-09 - **Hungary To Float State Highway Co Stake Via IPO**

BUDAPEST (Dow Jones)-- Hungary plans to sell a 75% minus one vote stake in state-owned highway management company **Allami Autopalya Kezelo Zrt.**, Hungary will float the stake via an initial public offer. The government will offer the shares to domestic retail investors and to domestic institutional investors. Analysts said the share offer is part of Hungary's attempt to lower its widening budget deficit. Highway construction before Jan. 1 2006 will be financed and accounted for in the state budget and construction activity after that date will be accounted for as outside the budget, Koka told the press. "There's a very clear dateline as for what is paid from the budget and what comes under public-private partnership. We want transparency and to avoid the confusion about the accounting seen earlier," Koka told the press. Hungary's budget deficit was the highest in the European Union last year at 6.1% of gross domestic product after the E.U. ordered Hungary to include its highway construction expenses in its budget. Hungary also plans to issue global bonds worth EUR1.18 billion to finance its highway construction plans, Koka said. Hungary will also draw on a loan of EUR320 million to be supplied by the European Investment Bank, to finance its extensive highway construction projects. Hungary targets this year's budget deficit at 4.7% of GDP but analysts put it closer to 7%-8% of GDP. The IPO will be carried out within six months via the Budapest Stock Exchange. Hungary plans to raise 30 billion forints ($147 million) through the share offer. The bonds will be issued in euros at the end of May at the earliest. The government will sign a 75-year contract with AAK to manage the highways in the second half of May. In a second phase of the government's plans for raising debt for highway construction, Hungary will seek about EUR400 million in bonds or bank loans at an unspecified later stage, Koka added.

2006-06-06 - **Hungary Economy Minister Pledges Railway Co Overhaul, Partial Sale**

BUDAPEST (Dow Jones)--Hungary's Economics and Transport minister elect Janos Koka pledged Tuesday to overhaul the country's state-owned and heavily indebted railway company **MAV Zrt.**, involving the partial sale of some operations. To boost company's efficiency MAV's operations will be divided into personal transport, cargo, real estate management and administrative units, Koka said before a parliamentary committee after his nomination to remain in the post of Economics minister. "And MAV Cargo will be prepared for privatization," Koka added. Besides the railway sector, Koka said he also plans to focus on public transport overall, the energy sector, and research and development. "For the interest of energy supply safety and to prepare for full energy market opening, we need diversification of supply and a (new) energy policy concept, " Koka said.

2006-06-19 - **Hungary Railway Co To Sell Cargo Unit To State**

BUDAPEST (Dow Jones)--Hungarian state-owned railway company **MAV Zrt**. is planning to sell its cargo unit MAV Cargo to the state privatization agency APV Rt. in a bid to boost its own capital, national daily Nepszabadsag said Monday without quoting sources. The selling price for the independently operating cargo unit is 80 billion forints ($370.5 million), the paper said. The move is designed to secure MAV's operation, which expects its losses to amount to HUF80-90 billion this year. The troubled railway company has already used up its own capital, which stood at HUF55.5 billion at the end of 2005, the paper added. By selling the unit to another state-owned company, the government wouldn't have to include the purchase price into its already bloated budget. The Hungarian government has recently raised its 2006 budget deficit sharply, from 4.7% of gross domestic product to 8% of GDP. APV could use its privatization revenues to buy the cargo company and under European Union budget calculation methodology this expense can be kept off-budget, the paper said. The move could serve as a lifesaver for MAV only this year and the company would need a capital injection from the state in the range of several tens of billions of forints in 2007, the paper added.

LATVIA

2006-06-13 - **SHB Shows Interest In Privatizing Latvian Mortgage Bank**

RIGA (Dow Jones)--Sweden's Svenska Handelsbanken AB has filed an application to privatize the state-owned **Mortgage and Land Bank of Latvia**, or Latvijas Hipoteku un zemes banka, branded as Hipoteku banka, a company executive said. Bo Kragh, Handelsbanken vice president and area manager responsible for the Baltic States, said the application had been filed "to secure an opportunity, but we are still far from any kind of transaction." The application was noted on the Internet Web site of the Latvian Privatization Agency, LPA. "Usually we don't comment or publicize matters that are at such an early stage, but we do confirm what is on the public record," Kragh told Dow Jones Newswires, but declined to give any further comment. In Stockholm, Handelsbanken's press officer, Johan Lagerstroem, said the application was a sign of interest should the Latvian government decide to privatize the bank and nothing more should be read into it. "This hasn't even reached the executive management level yet," he said. "We're constantly scanning the market all over the world for good business cases. This might be one of them," he said. Handelsbanken's confirmation comes less than two weeks after Inesis Feiferis, managing board chairman of Hipoteku banka, told a Latvian business newspaper that it was time to look for a private sector investor. Feiferis suggested that at least part of the shares of Hipoteku banka could be privatized.

POLAND

2006-02-16 - **Poland Wants To Sell 3.97% Stake in TPSA - Deputy Treasury Minister**

WARSAW (Dow Jones)--Poland wants to reopen talks with France Telecom (FTE) on selling its remaining 3.97% state-owned stake in **Telekomunikacja Polska SA**, said Deputy Treasury Minister Piotr Rozwadowski. France Telecom now owns a 47.5% stake in TPSA, which dominates Poland's fixed-line market and controls the country's number-two wireless operator Centertel. Poland's left-wing government engaged in protracted and ultimately fruitless negotiations with France Telecom in 2004-2005 about disposing of the stake. "We'd like to reopen these talks soon," Rozwadowski told a joint session of parliament's infrastructure and treasury committees. "But selling our stake would give France Telecom more than a 50% stake in the operator, which means we would expect them to pay a premium for control," Rozwadowski said. At current market valuation, 3.97% of TPSA would be worth 1.25 billion zlotys ($392.8 million).

2006-06-06 - **Polish Government Weighs Spinoff Of PGNiG Extraction Operations - Aide**

WARSAW (Dow Jones)--Poland's government is working on a plan to spin off exploration and production operations from state-controlled natural gas monopoly **Polskie Gornictwo Naftowe i Gazownictwo**, or **PGNiG**, a senior economy ministry official said Tuesday. "We need to split off...PGNiG's oil and gas reserves to ensure they remain under state control," Przemyslaw Wipler, the economy ministry's senior adviser on energy supply diversification, told reporters on the sidelines of an energy conference in Warsaw. The economy ministry, which is reponsible for devising a strategy to enhance the security of Poland's energy supplies, and the treasury ministry, charged with oversight of state-owned companies, are working together on a restructuring proposal. "Different options are being considered," Wipler said. PGNiG is 72% owned by the state. A 15% stake is held by financial investors after the company was floated on the Warsaw Stock Exchange last year, while 13% is in the hands of PGNiG employees. Poland's conservative government, which took office in October 2005, has been harshly critical of the previous left-wing cabinet's decision to float PGNiG. Prime Minister Kazimierz Marcinkiewicz said the government would take urgent steps to ensure strategic assets belonging to the gas monopoly - especially pipeline infrastructure - remained under state control. However, the government hadn't previously disclosed any plan to strip PGNiG of its upstream operations.

SLOVAK REPUBLIC

7 Jun 2006 - **Slovak Regulator Postpones Airports Sale Ruling To August 14**

PRAGUE (Dow Jones)--The Slovak Antimonopoly Office has postponed until Aug. 14 a decision on whether to approve the sale of the state-owned Bratislava and Kosice airports to Austria's Flughafen Wien AG, awarded on February 13th, 2006. The decision, scheduled for June 8th, has been postponed due to the complexity of the issue, the office said in a statement. The deal has already been approved by Slovakia's government, but needs the green light from the regulator. Austria's competition authority cleared it in April. Flughafen Wien, the operator of Vienna International Airport, heads the consortium that in January submitted the winning bid for a 66% stake in the two airports. It offered approximately 11.4 billion Slovak koruna ($1=SKK29.55) and pledged a further capital investment of between SKK8 billion and SKK9 billion. The consortium, called TwoOne, includes Czech-Slovak private equity group Penta and Austria's Raiffeisen Zentralbank Osterreich. Slovakia is to hold a general election June 17.

Table 1. Announced Deals

Date of Announcement	Company Name	Country	Percent for Sale	Method of Sale	Date Expected (as announced)	Rescheduling /Notes
Jun-06	Alitalia	Italy	unspecified	unspecified	unspecified	
May-06	Pages Jaunes	France	up to 54	unspecified	unspecified	
Apr-06	DONG	Denmark	28.00	Public Offer	1H2005	postponed to 2007
Mar-06	Piraeus Port Authority	Greece	unspecified	unspecified	2007	
Mar-06	British Nuclear Group	UK	unspecified	Public Offer	unspecified	
Mar-06	Urenco	UK	33.00	Public Offer	unspecified	blocked
Mar-06	Westinghouse	UK	100.00	Private Sale	end 2007	completed
Mar-06	Scottish Water	UK	unspecified	Public Offer	unspecified	
Feb-06	Ren	Portugal	70.00	unspecified	2006 or 2007	
Feb-06	Energias de Portugal	Portugal	unspecified	unspecified	2006 or 2007	
Feb-06	TAP Air Portugal	Portugal	unspecified	unspecified	2007	
Feb-06	ANA	Portugal	unspecified	unspecified	2007	
Feb-06	Inapa	Portugal	15.00	unspecified	2006 or 2007	
Feb-06	Portucel	Portugal	25.70	unspecified	2006	
Feb-06	SDU NV	The Netherlands	up to 100	Private Sale	2006	
Feb-06	OTE	Greece	38.60	unspecified	2006	postponed to 2007
Feb-06	Berliner Bank	Germany	unspecified	Private Sale	end 2006	completed
Feb-06	Depa	Greece	unspecified	Public Offer	unspecified	
Jan-06	Connexxion	The Netherlands	66.6	Private Sale	2006	
Jan-06	Dagris	France	64.70	Private Sale	2006	
Jan-06	Qinetiq	Uk	47.60	IPO	February 2006	completed
Jan-06	Agricultural Bank of Greece	Greece	up to 23,8	unspecified	2006	
Jan-06	Emporiki Bank	Greece	41.00	Private Sale	2006	
Dec-05	SEA Milan SpA	Italy	33.00	Public Offer	2006	postponed
Dec-05	Koninklijke KPN	The Netherlands	unspecified	Public Offer	unspecified	
Nov-05	Telekom Austria	Austria	up to 30	unspecified	after autumn 2006	
Oct-05	Scandlines AG	Denmark & Germany	100.00	Private Sale	2Q2006	
Oct-05	Eni SpA	Italy	10.00	Public Offer	2006	
Oct-05	Enel SpA	Italy	10.00	Public Offer	2006	
Oct-05	Atomic Energy Agency	UK	unspecified	Private Sale	unspecified	
Sep-05	Schiphol Airport	The Netherlands	up to 49	IPO & PS	November 2006	
Sep-05	Izar's Assets	Spain	unspecified	Private Sale	unspecified	
Jul-05	Red Electrica	Spain	10.00	Public Offer	unspecified	
Jul-05	VVF Vacances Holiday Arm	France	20 to 30	Private Sale	end of 2005	
Jun-05	Snam Rete Gas	Italy	up to 30	unspecified	2005	postponed to 2008
Jun-05	GalpEnergia	Portugal	20.00	IPO	2006	
Apr-05	GIMV	Belgium	30 to 35	unspecified	unspecified	
Jan-05	Athens Intl. Airport	Greece	up to 55	unspecified	2005	postponed to 2007
Dec-04	Olympic Airlines	Greece	unspecified	Private Sale	2005	postponed to 2006
Oct-04	Iberia	Spain	5.30	Private Sale	2005	
Oct-04	Endesa	Spain	3.00	Public Offer	2006	
Oct-04	TV2	Denmark	51 to 66	Private Sale	1Q2005	postponed
Sep-04	Aeroports de Paris	France	up to 49	IPO	1Q2005	completed
Sep-04	RAI Radiotelevisione Italiana	Italy	20 to 30	IPO	1Q2005	postponed
Sep-04	Aguas de Portugal	Portugal	up to 49	IPO	2H2005	postponed
Sep-04	EDP	Portugal	up to 20	Public Offer	2004	postponed to 2006 or 2007
Jun-04	Deutsche Bahn	Germany	25 to 30	IPO	2006	postponed to 2008
Mar-04	Oesterreichische Post AG	Austria	49.00	IPO	end of May 2006	completed
Jan-04	Deutsche Flugsicherung	Germany	up to 50	unspecified	2005	postponed to end 2006
Jan-04	Postal Savings Bank	Greece	up to 40	IPO	2006	completed
Jan-04	Aer Lingus	Ireland	up to 60	IPO	2005	September 2006

Source: Elaborations on *DowJones*, and *Privatization Barometer.*

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