"We Did Not Neglect Institutional Development"
Interview with World Bank’s ECA Chief Economist Marcelo Selowsky

There are tremendous differences among the transition economies. Countries in Central Europe close to EU accession are growing rapidly, even faster than Western Europe. On the other hand, the largest transition country, Russia, is in economic crisis. What can explain this highly divergent performance? What should have been done differently in Russia? Transition editor, Richard Hirschler, posed these questions to Marcelo Selowsky, chief economist of the Europe and Central Asia Region at the World Bank.

Mr. Selowsky has done extensive writing on macroeconomic and debt issues, and for more than a decade, focused his research on poverty issues and investment in human resources. He did pioneering work on the economic cost of infant malnutrition and drew attention to the need to integrate social programs for very young children into the overall investment in human capital. He served as chief economist for the Latin America and Caribbean Region during that region’s debt crisis.

Q. The 1998 World Bank IMF Meetings were held in exciting times: the Asian crisis is far from over, a world recession is looming; Russia’s economy is disintegrating and the government is still looking for a suitable economic policy. In light of all this, how do you see the prospects for the transition economies in 1999?

A. In Central Europe and the Baltics much will depend on growth in Western Europe and on the price at which international capital markets are willing to lend to cover these countries’ current account deficits. Present growth rates will be affected if an abrupt reduction in these deficits are necessary, as a result of lower exports and difficulties in finding external finance. It is key for these countries to intensify policy improvements to keep attracting foreign direct investment (FDI) and accelerate the process toward EU accession. Countries in the CIS bordering Russia will feel the effects of the Russian crisis—Russia accounts for about 25-30 percent of their exports. Whatever happens to world prices of oil, minerals, and cotton, it will also affect their growth prospects. As far as Russia is concerned, inflation could accelerate sharply as a result of monetary expansion to cover pension and wage arrears and losses in the banking sector. It is crucial for Russia to strictly prioritize government expenditures and quickly reestablish control of tax revenues. This will allow the present inflationary burst to be a temporary one—aiming then toward a gradually declining inflation rate.

Q. With hindsight, what do you think of the Kiryenko government’s summer agreement with the IMF, and the subsequent commitment of the Bank to provide an additional $1.5 billion loan? With all signs indicating a necessary ruble devaluation, why was the financial community ready to provide billions of dollars to postpone the unavoidable for a few weeks?
A. The summer agreement tried to re-establish confidence in the markets by providing additional financing as well as obtaining from the government a commitment to accelerate fiscal and structural reforms. Some of these reforms were to be instituted immediately and involve legislative passage by the Duma, particularly on the tax front. As seen at that time, there was a chance—and one can debate the magnitude of that chance—that fulfillment of the program could have convinced markets to reduce the extremely high-risk premium that investors were demanding—interest rates on the order of 100 percent—in return for refinancing the maturing treasury obligations. These maturing obligations, coming due over the next 12 months, were quite large relative to GDP—around 10 percent—and relative to the country's foreign exchange reserves. Hence, there was a clear risk that the financing package would not be large enough to bolster the market's confidence.

Unfortunately that risk did materialize. Although the Duma approved several tax measures, it failed to approve the overall tax package, which then had to be passed through decrees. That reduced the expectations of sustained improvements in revenues. In addition, during June, the Asia contagion reached its peak as a result of growing political and financial turbulence in Indonesia. Both factors turned market sentiments further against Russia in spite of the summer agreement.

In my view, the summer agreement with the Kiryencko government should have been a “general equilibrium agreement,” incorporating not only the Russian government and the international finance institutions but also creditors holding short-term public debt and the G-7 governments. Out of the group, only Japan contributed to the financing package. We needed four players—and we had only two.

I believe that an early, orderly, and transparent agreement with Russia's creditors on replacing short-term debt with long-term dollar obligations, at interest rate spreads that were prevailing before the East Asian contagion took hold, would have taken the pressure off Russia's public finances and the ruble's exchange rate, and helped to spread these pressures over the medium term. Because part of the short-term debt was held by domestic commercial banks, the G-7 governments' financial contribution could have been used to shield depositors from a deterioration of the banks' balance sheets. The breathing space could then have been used to consolidate fiscal and tax reforms and help the country to move gradually toward an exchange rate realignment. In summary, we needed an early and orderly process of wide burden sharing.

As far as the World Bank is concerned, as part of the summer package, only $300 million of the $1.5 billion committed under the third structural adjustment loan (SAL III) was disbursed immediately. Future disbursements are contingent on further progress on the structural front.

Q. Many experts are blaming the international finance institutions because several transition economies, primarily Russia, after six to eight years of experiments with market-oriented economic policies, are experiencing rampant poverty, lawlessness, and corruption; their banking sectors are weak, their fiscal imbalance chronic, their foreign trade structure unhealthy; and they trade primary products (oil, gas, minerals, timber) for food, consumer goods, and other manufactured products. Of course, one cannot blame the international finance institutions (IFIs) for all the problems. Nevertheless, do they bear responsibility for these developments? What would the Bank do otherwise if it had the chance to start over?

A. Let me begin with some facts. The transition economies in Central Europe and the Baltics that have undertaken market reforms have been growing fast for several years—faster than Western Europe. Those that have lagged in growth, such as Romania and Bulgaria, are precisely those that have also lagged in the reform process. Bulgaria is now reforming quickly, however. Countries in the Caucasus and the Kyrgyz Republic also are growing fast. So today Russia and Ukraine are more the exception than the rule, and the question is why growth has not resumed in these countries.

Reform in Russia and Ukraine has been interrupted abruptly several times during the past six years in an atmosphere of very sharp confrontation between the executive and the legislative branches. Many policy reforms have been implemented through presidential decrees rather than through legislation, thereby reducing the expectations of sustainability of such reforms.

Russia's initial conditions were also very different from those in Central Europe. Labor mobility and restructuring became much more difficult, due to the very large share of military output and negative value-added industries, and the dominance of large company towns, the sole employers for a whole community, artificially located in remote regions, originally, for strategic reasons. This is compounded by the absence of an inherited legal framework that is supportive of market development and property rights.
All these factors—erratic progress in reform and difficult initial conditions—have made it more difficult for these economies to rapidly respond to improved incentives. This can be documented clearly by the low level of foreign direct investment (FDI) and slow growth of small firms in Russia relative to other transition economies.

What could have been done differently? Several observers have suggested that slower trade and price liberalization would have given money-losing enterprises more time to restructure and adjust. But this would have also slowed down the incentives for growth for those sectors that had a true comparative advantage, but were repressed due to the original price and trade controls. The downsizing and restructuring of firms—while incorporating social concerns—can be better helped by direct budget transfers to the affected communities than by slowing price liberalization or covering losses of these enterprises. An important objective of reforms—supported by the World Bank from the start—was to shift subsidization from enterprises to poor households and communities. I am still convinced that this is the way to go.

Great concerns did emerge, however, regarding transparency, equity, and concentration of market power in the second stage of privatization—the loans-for-share program for large enterprises. And the Bank made this known to the Russian government at that time. At present, the government is considering adopting a more elaborate form of case-by-case privatization for large enterprises which, if implemented, should ensure much greater transparency and competition.

Another area of criticism is that external assistance focused too much and too prematurely on liberalization and privatization and less so on progress on the institutional and legal fronts. We all had wished for faster progress on that front. But it is also an area where the initiative for change basically must come from within the country—there is only so much that can be achieved from the outside. Civil society first must recognize the need for legal and institutional reform. The Bank has supported reform in these areas but progress has not been easy. Let me give you an example: Since 1992 the Bank has been working with the authorities in developing a better land code that would allow for unconstrained land ownership and freedom-for-land transactions. However, so far no consensus has been achieved between the executive branch and the Duma that would have allowed for the passage of such legislation.

Should price liberalization and the first wave of privatization have waited for at least a minimum of progress on the institutional and legal reform front? Can really market-supportive legal institutions be created before the markets themselves begin to emerge? One needs a minimum of private property and depoliticized markets to generate an effective demand for market-supportive institutions, such as independent courts, transparent bankruptcy procedures, and the like.

What should the Bank have done differently? In hindsight there are three areas in which the Bank probably could have pressed for stronger government action. First, faster reforms to unbundle and demonopolize the oil and gas segments, to encourage new private investment and entrepreneurship. Second, a tougher stance on tax collection, particularly from large tax debtors. And third, a faster improvement of the prudential and regulatory framework governing commercial banks, including enforcement. But vested interests in these areas were known to be strong—bolder government actions would have required a consensus on several levels and a much stronger commitment to reform by the executive.
Q. In particular, a revision of the Washington Consensus emerged as an important part of the Bank’s renewal process (see Transition, June 1998). It is hoped that, with a new approach, more appropriate tools can be applied to many of the problems of the transition economies, including: more focus on the social effects of the stabilization-liberalization-privatization triad, control of short-term capital movements, confronting other undesirable side effects of globalization, and, greater emphasis on institutional development. Do you agree with these?

A. You ask me about the Washington Consensus. As far as I know, the Washington Consensus lately has become a label for a strategy aimed at achieving privatization, liberalization, fiscal deficit and inflation reduction as fast as possible, and also making the state as small as possible—with little regard to social issues, human capital accumulation, and progress on the institutional side. Defined that way, I find it a caricature, and hence not a helpful starting point to discuss many of the policy dilemmas and trade-offs that are still on the table. Consequently, I will address directly the three specific questions you have raised, particularly in reference to the transition economies.

The social cost of stabilization obviously can be reduced by higher levels of concessional external finance—we all wish the amounts could be larger. But such amounts are limited. We have been very active in mobilizing donor support, particularly for the low income countries in the Caucasus, Central Asia and also for the postconflict countries.

On the domestic side, slowing down price liberalization is not a good vehicle for social protection. Direct budgetary transfers through targeted social assistance programs better serve this purpose. We have used projects and adjustment operations intensively to achieve such targeting, combined with technical assistance to the institutions in charge. We have been involved heavily in assisting pension reform and in protecting basic pension levels. We are also assisting the restructuring and downsizing process of some industries by setting up retraining programs for workers in the affected communities and helping local communities take over the social services, previously provided by such enterprises. The communities themselves are active in designing such programs—they are not “predetermined” in Washington.

Let me discuss the issue of controls on short-term capital inflows. Everyone acknowledges that a buildup of short-term external debt by the government or the private sector made economies highly vulnerable to volatility in capital markets’ sentiments. When too much capital is flowing to finance the fiscal deficit, the solution is to reduce the deficit, not control capital inflows. The situation is different when large inflows are being channeled toward the private sector through the banking sector. In this case tight prudential regulations and limits on short-term open positions or currency mismatches of the banking sector are the first line of defense. Enforcement and depolitization of the supervisory agencies are crucial.

As I mentioned earlier, we need to intensify our work in this area. The issue is, whether in addition, one should impose Chilean-style reserve requirements that act as a tax on short-term flows. I believe such an idea has merits and should be discussed with governments as an option. There are some costs: imposing a tax on short-term flows when the private sector is starting to attract such financing may prematurely kill the learning process by which creditors gradually move toward providing longer-term financing. Creditors will wish to see a track record of servicing short-term loans before moving toward longer-term ones.

Finally, let me turn to institutional development. We have not neglected this area—and neither have other donors—although I am sure we should do much more. In Russia, the Bank has supported reform in a wide variety of areas, including land registration initiatives, antimonopoly legislation, shareholders protection, and the like.

IFC—a member of the World Bank Group—has been heavily involved both at the policy and grassroots levels, assisting in reform of the Civil Code, Company Law, securities regulations and corporate governance training. IFC also piloted a large land reform project. So far the Economic Development Institute (EDI) has organized training courses for about 5,000 instructors in Russia and for about 1,000 in Central Asia in areas such as economics, banking, social sector policy, and the environment.

A specific project has assisted Russia’s Security and Exchange Commission to improve the regulatory framework of the security market. Through a Legal Reform Project and the help of the Legal Department, we are assisting in drafting new legislation and streamlining the legislative process; this project has an important training and education component for judges, courts and law schools. And we are in the course of preparing similar projects in several other countries in the CIS. All these initiatives will need time to be effective—by their very nature they are aimed at profound change of behavior and habits of many actors in the society. Political consensus becomes a fundamental prerequisite for progress. As we move to a second generation of reforms, institutional change will increasingly become more important.
Setting Russia’s Economy on a New Path

One late October afternoon, a remarkable meeting took place at the World Bank. A group of influential Russian and U.S. economists—including Oleg Bogomolov, Stanislav Menshikov, Michael Intrilligator and Nobel laureate Kenneth Arrow—met with First Deputy Treasury Secretary, Larry Summers, and several Russian experts of the World Bank and the IMF. The meeting—chaired by Joseph Stiglitz, chief economist and senior vice president of the Bank—explored the causes of Russia’s economic breakdown and the necessary policies to overcome the crisis. One group argued that demand-boosting measures would break the vicious cycle, and lift Russia out of its present quagmire. The critics, on the other hand, insisted that within the present economic structure, stimulating demand would lead merely to higher inflation, with no appropriate supply response. The views thus remained apart, but the dialogue continues, and hopefully will contribute constructively to the ongoing reassessment of Russia’s economic policy. The following article by Professor Nekipelov, director of a major think tank in Moscow, introduces interesting new elements in the ongoing discussion. The Editor.

The Nature of Russia’s Economic Catastrophe—An Alternative Diagnosis
by Alexandr Nekipelov

In accordance with the standard approach to macroeconomic stabilization “radical reformers,” the governments headed by E.Gaidar, V. Chernomyrdin, and S. Kiryenko, had concentrated on fighting inflation at any cost, believing that when inflation was defeated, the economy would soon begin healthy growth. When it turned out that stable prices and foreign exchange rates are not sufficient for this purpose, it was accepted that fiscal policy had been too soft and, as a result, private investments, which are necessary for growth, were crowded out by the state. It followed then that economic growth critically depended on fiscal austerity.

The Kiryenko government hoped that balancing the budget would not only have a positive impact on economic growth, but would stop the outflow of foreign capital from the short-term state bond market and thus would help stabilize the foreign exchange market. The measures that the earlier government took to increase tax collection, were purely administrative, rather than a final cause. This is why trying to overcome the deficit by mechanically increasing budget revenues and slashing expenditures, will eliminate consequences rather than causes. Russia’s financial crisis is not an autono-
Mystery of Liquidity Crunch

Thus the lack of liquidity in Russian enterprises, rather than the lack of political will, was the real reason for their failure to consolidate the financial situation. In order to restore liquidity in the real economy, one has to understand the origins of this phenomenon. Many believe it is linked to insufficient money supply; there is too little money in the economy relative to the existing price level (holding the level of output and money velocity as given). These scholars usually refer to two major facts: a drastic reduction of money supply in real terms during Russia’s reform process and a very small ratio of M2 aggregate to GDP, as compared to developed market economies. From this perspective, nonpayments, barter transactions, and money surrogates are simply substitutes for cash; they are results of the adjustment to the insufficient money supply. The recipe, therefore, should be to satiate the economy with the liquid means of payments, increasing the level of monetization.

The radical reformers have always criticized this approach, but they never put forward a satisfactory explanation for why the Russian economy gradually has been transformed into a practically in-kind economy. The Kiryenko government blamed the insufficient amount of credits to the real sector for the demonetization of the economy. There was some logic to this position: lack of credit demand was a result of high interest rates, which were rooted in the huge budget deficit. This position supported the general idea of concentrating all the efforts of the executive power on toughening the fiscal policy.

But it is easy to prove that this position is unfounded. First, it is difficult to comprehend the mechanism that transforms the lack of credits into the weak liquidity of the real sector. The fact that enterprise “A” has not been granted a bank credit to finance its current needs in no way means that its suppliers should automatically extend this credit themselves. Second, bankers are aware that their credit can help a customer buy the necessary inputs, but does not guarantee marketability to a product. Thus the lack of liquidity in the real sector is a very strong obstacle against moving loanable funds there, rather than the other way around—the lack of credit being the main cause of arrears. The radical reformers’ explanation of insufficient liquidity of the real sector is nothing more than a variation of the concept that the Russian economy suffers from an excessively restrictive money supply.

In a genuine market economy such a phenomenon as “shortage of money” is simply impossible. Equilibrium in financial markets (including the money market) is constantly maintained due to the ability of the interest rate to react immediately to any changes in the supply and demand of money balances and other financial instruments. The transmission mechanism (money supply—interest rate, investment and some consumer demand—prices, real money supply, interest rate) ensures that all real variables return to their equilibrium positions in the long run, whereas price is adjusted to a new level of nominal money supply. There is no place here for barter transactions, arrears, and money surrogates as substitutes for insufficient money supply. Not much will change if we allow for the downward stickiness of prices in the Russian economy, because of its high level of monopolization. For instance in the case of falling money supply, the difference would consist of a smaller output and higher prices, as compared to a perfect market structure, but not in a money shortage.

The emergence of an in-kind economy in Russia cannot, therefore, be explained on the basis of the theory of the market economy. This does not mean that the latter is false; the real sector, stripped of money, is a product of deep deformations in the foundations of the Russian economic system, its quasi-(or pseudo) market nature. There is no need to deny the facts: a gap between price level and money supply is a reality in Russia, whereas mutual arrears—barter transactions and the like—adjust our enterprises to demand constraints. But this type of adjustment has little to do with the standard behavior of market agents under similar conditions (letting prices down, reducing output, or both).

Consequences of a Quasi Market

Demonetizing the economy (though one of the most important) is only one manifestation that Russia’s economic system has a specific character. Under normal conditions, the profitability of cur-
The quasi-market nature of the Russian economy helps to explain its sometimes strange reactions to standard applications of fiscal and monetary policy. Under a market economy, reduction of government spending cannot lead to a growing budget deficit (though it is accepted that the absolute volume of taxes can decline, but to a lesser extent than expenditures). However, if a substantial number of firms lack hard budget constraints, the result of such fiscal austerity is not so obvious. A decline in government expenditures can produce a surge in nonpayments and, as a result, a much steeper fall in tax collection than in the case of a “normal” market economy.

Naturally, to accept the existence of the Russian market anomaly is only the first step. More important is to determine what factors generate it. The Russian postcommunist experience shows that under certain conditions, even privatizing a significant portion of state assets may not be enough to guarantee genuine market transformation of the economy. As a consequence of the mass privatization that took place in Russia, property rights reform was characterized by total and logically inexplicable ignorance of the need to control these assets that still belong to the state and a purely political approach to privatization. A purely political approach to privatization meant that the reformers attached maximum importance to the speed of the process, believing that whatever was responsible for the primary distribution of public wealth in private hands, after privatization the market mechanism would redistribute the rest to the most capable entrepreneurs. The result was that the management staff of most big and medium-size firms found itself unsupervised—a function of the owners of capital (either state or private). This explains the distorted economic behavior of enterprises, including supplies of goods against nonpayments or money surrogates. The asset-stripping epidemic in both state and privatized firms (criminalization of economic activity) is rooted in the inadequate corporate governance system established in Russia during the reform of property rights.

Unusual behavior of the government (at the federal and regional levels) is also a specific feature of our economic system: including the systematic breaching of its own commitments (huge arrears in payments of state orders, salaries of those who work in the budget sphere, pensions, and the like) and the coercing of businesses to supply goods or services to customers who do not have money to pay for them. Nonpayments by the state in large part caused the arrears in the real sector. If such government behavior took place in a genuine market economy, the result would be mass bankruptcies of those enterprises that had contracts with the government (as well as of their creditors) rather than demonetization of the real sector of the economy. The paradox is that based on their experience, our radical reformers were very well aware of the unusual reactions of Russia’s real sector to such government behavior.

They, therefore, consciously exploited the quasi-market nature of the economic system they created.

Collapse Was Inevitable

Almost all market institutions are formally in place in Russia—a two-tier banking system, all major financial and trade intermediaries, and stock and foreign exchange markets. But this market infrastructure is little more than Potemkin’s village. Commercial banks have never extended much credit to the real sector of the economy. First they were making money on high inflation and foreign exchange speculation, then on extremely profitable GKOs. Some of them (those belonging to the “oligarchs”) had the privilege of maintaining and servicing government accounts. By artificially slowing the settlement of payments, these banks gained additional sources for short-term speculative investments. The banks bought industrial firms because of expectations of huge capital gains, resulting from the initial heavy underpricing of assets (often the privatization price was much less than the firm’s liquidation price). The stock market, in its turn, has never played any role in allocating resources—being a playground for speculation on the shares of several dozen enterprises that produce and export raw materials.

This was a consequence of a deeply erroneous strategy for market transformation in the Russian economy. It is impossible to maintain a normal financial infrastructure along with a demonetized real sector of the economy. Strong incentives for the financial and trading sectors to serve the process of wealth consumption (rather than wealth creation) and redistribution have been built into the system. It helps to understand the unprecedented high real interest rate that has been holding for years on a level many times above the rate of return in the real sector.
Of course, such a mechanism of economic annihilation could not go on forever. The government increasingly was unable to finance basic social needs (along with drastically reducing expenditures) and was forced to lean heavily on domestic borrowing. This pushed interest rates further up and made servicing of domestic debt increasingly difficult. In order to make borrowing cheaper and thus facilitate the servicing of debt, the government and the Central bank, in 1995, decided to open the securities market to foreign short-term speculative capital. So a strategic decision was taken based on purely tactical considerations. Though it was advertised as a new important step toward economic liberalization, it was in fact the last means of prolonging the existence of an absurd economic system.

A massive inflow of foreign capital did occur. Reserves of the Central bank increased, the ruble supply began a steady increase without any immediate danger to the exchange rate and price stability (though without any positive effect on the level of “monetization” of the real sector), interest rates began to fall. However, tax collection didn’t improve. Commercial banks were quickly moving in a highly leveraged position, drawing heavily on foreign exchange borrowing to finance ever-increasing investments in GKO’s.

It would be a great mistake to believe that if it were not for the Asian crisis, the economic situation would normalize in Russia. Not at all! The stock of short-term foreign capital invested in government securities would have stabilized at some interest-rate level, and the problem of financing the budget deficit would have been reproduced at a new level. Within the pursued course of reforms, sooner or later, financial (or social, in the case of excessive cuts in budget expenditures) collapse would have become inevitable.

Blueprint of an Economic Strategy

In light of the diagnosis, we are suggesting the following therapy.

Changing the behavior of economic agents and overcoming the crisis of arrears.

Among the measures necessary to provide for market transformation of the Russian economy, corrections in the property rights aimed at establishing efficient corporate governance should play a key role. Putting the management of joint-stock companies under the control of the owners of capital and making them maximize the profits (in the short run) and the net worth of the firm (in the long run) are subject to the solution of two problems. The first one is the introduction of legal mechanisms providing for shareholders to fulfill their functions as bysubess owners. These mechanisms are being instituted and the task is to complete it successfully and quickly. The second problem is, under current conditions, the main one, though not enough attention is being paid to it—the introduction of a system that would guarantee a market-compatible style of asset management by a specific owner, the Russian State.

The government is still the main owner. According to some estimates, up to half of all assets, including significant shareholdings in privatized firms, belong to the State. The absence of a rational system of state assets (in particular, state-owned shares) management deforms the behavior of large and medium-size Russian enterprises. The usual decisions of managers are often possible only because one of the biggest shareholders—the State—shows no interest in how its capital is used.

The situation could be remedied if all state-owned shares were managed by a specially instituted state holding company (an alternative solution—by a number of such companies). Concrete mechanisms providing for this company have been elaborated, following the target of net worth maximization. It has also been shown that such a state company should in never be subordinated to the executive power, rather, it should have a status similar to that of the central bank.

It is also extremely important to change radically the relations established between government bodies at different levels and economic market agents. True, very often authorities use their power in a way that is totally incompatible with the principles of a market economy (that is, not respecting their own contractual obligations, forcing firms to supply goods and services to insolvent, but “socially important” enterprises, executing administrative pressure to prevent firms from reducing their personnel even when they have no possibility to sell their output, and so on) because they have no other ways to address important economic and social issues. This behavior, therefore, turns out to be a natural way to operate in an irrational economic system. But it is also true that continuing such actions can only freeze the existing impasse.

It is justifiable to introduce a procedure that would automatically trigger the printing of money at those times when the federal government cannot honor its commitments. Such a measure would raise the government’s responsibility radically rather than lead to growing inflation. It would create conditions for the Russian economy to function according to market principles, and thus it would eliminate the systemic causes of “demonetization”
of the real economy. Under rigid control of the owners of capital, firms will not supply goods to insolvent partners; those who do will go bankrupt.

Measures such as printing money more, although necessary, are not sufficient. This is because "reformed enterprises" will not be able to overcome the lack of liquidity in the real economy. Declaring bankruptcy can hardly solve the problem; there was so much demonetization in that it was leading to complete disorganization and chaos. I do not believe that a gradual saturation of the economy with money through the operations of the Central bank would solve the problem; the economy can't wait. A radical decision is required: clearing the financial field with an overall mutual nonpayments set-off in a one-strike saturation of the real economy with money, according to market rules. Technically it means that mutual arrears of all economic agents are netted out simultaneously. The accounts of those with a positive debt balance (receivables exceed payables) should be automatically credited with the respective amount. If the debt balance is negative it should be transferred to the government, which, in accordance with its industrial policy priorities and financial resources, would decide whether it wants to transform it into long-term credit, convert it into ownership, or allow respective enterprises to go bankrupt.

It is important to assure a simultaneous clearing of wage arrears. Simple money printing by the state, in order to pay wage arrears of defaulted enterprises, could destroy the consumer market. In contrast to the real sector, this increase in the money supply is not a substitute for nonpayments and money surrogates. Therefore, inflationary methods should be preferred. For example, the workers (or special institutions acting on their behalf) should be entitled to exchange wage arrears for stocks on a favorable basis or to initiate a bankruptcy procedure. Taking into account possible inflationary pressure as a result of the overall arrears set-off, the following measures seem useful:

- Freezing prices for several months
- Restoring a foreign exchange rate corridor to provide an anchor for domestic prices
- Adjusting the economy for inflation through such measures as an inflation-adjusted accounting and tax system and the automatic indexation of nominal contracts.

Normalizing the financial sphere

It makes no sense to blame the financial intermediaries for the lack of credit to the real economy when speculative investments are not only much more profitable, but less risky. The above-mentioned measures aimed at genuine market transformation of the Russian economy and its "monetization," with the aid of the overall arrears set-off can change this situation and overcome an abyss between the spheres of financial and trade intermediation, on the one hand, and production, on the other. Unfortunately, now we are facing not only systemic financial problems, but critical current issues linked to the collapse of the banking and, as a result, of the settlement of payments systems that put the economy on the edge of chaos.

Strategically, two main approaches can be used now to remedy the situation:

- The first, standard one consists of applying selective bail out procedures to the banking system. Saving the minimal number of banks necessary to restore a normal settlement-of-payments system may be accompanied by their temporary nationalization. Along with the introduction of a set of measures elaborated by the Basel's committee on bank supervision (1997), some additional steps probably will be necessary to improve the safety of the banking system. In particular, a reconsideration of attitude toward banks' investments in the stocks of domestic and especially foreign companies seems to be expedient. The usefulness of banks' participation in privatization is often justified by their ability to play the role of a strategic investor and thus to provide efficient corporate governance. This argument turned out to be false because so far banks have invested in productive assets seeking huge capital gains exclusively. On the other hand, the volatility of stock market prices makes shares a risky investment and thus undermines banks' safety. It would, therefore, be advisable if commercial banks concentrated on extending credit to firms to finance their working capital needs. The main problem with this approach is that it needs a lot of money which, under the current fiscal crisis, can be printed. According to an estimate announced by First Vice-Premier Maslyukov, approximately 60 billion rubles (about 2.5 percent of GDP or 30 percent of base money) are needed to bail out a minimal number of big banks. That is why another approach deserves attention.

- Taking advantage of Sberbank, a unique quasi-state savings bank with branches practically everywhere, a parallel system for settlement-of-payments could be quickly established. To make it absolutely safe, a 100 percent reserve requirements for transferable deposits in Sberbank could be introduced, which, of course, would mean that the clearing services would require payment. Participation in this system ought to be voluntary, with the old one remaining in force, based on partial reserves. This action is designed to give the Central bank and the government an opportunity to decide calmly what to do with the collapsed banking system without running the risk of chaos. Its realization could drastically reduce the amount of money that must be printed just to restore the settlement-of-payments system.

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Stabilizing the foreign exchange market

According to Chase Manhattan Bank, from August 1998 to the end of 1999 the Russian government has to pay foreign creditors $22.3 billion, from August 1998 till August 1999, whereas for the same period Russian commercial banks and other economic units have to pay $16.4 billion. Under these conditions it seems necessary to take urgent measures to stop foreign currencies (first of all, the U.S. dollar) from being one of the most important assets in the Russian economy and limiting their role in international payments. An obligatory

Russia’s Economic Program

*Kommersant Daily*, the Moscow-based business paper, published end-October the latest version of the government's latest version of the anticrisis plan. It calls for some price controls, payment of back wages to workers, and the revival of Russia’s depressed industries. Some major points of the plan:

- The ruble will have a floating exchange rate. Economic and administrative measures will be undertaken against banks and other institutions that launch speculative attacks on the ruble.
- Obligatory sales of hard currency by exporters will be raised to 75 percent of their hard currency receipts. The time frame for hard currency receipts to be turned in will be shortened for many sectors, including to 30 days for oil and gas exports.
- From January 1, 2001, the Central bank will rescind licenses of banks with capital of less than one million ecus and of nonbank credit institutions with capital less than 100,000 ecus. In the meantime, the commercial banking industry will be restructured. The central bank will issue credits to banks that offer either hard currency as collateral or a controlling interest in their organizations. Hard currency operations of commercial banks will be strictly controlled.
- Russia's frozen state securities will be restructured and secondary debt trading will resume. A unified system to monitor and manage Russia's state debt will be established and will include the debts of regional administrations, enterprises, and banks.
- All budget receipts will be transferred into a single account under the control of a federal treasury.
- A restructured and simplified tax system will include:
  - Gradually reducing the value-added tax (VAT) and eliminating it on purchases of foreign firms when advance payment is made to exporters
  - Cutting profit tax from 35 percent to 30 percent, with up to about one-fifth going to the regions
  - Eliminating tax on profits reinvested in industry
  - Introducing property tax equal to 0.5 percent of the property's market value.
  - Imposing higher penalties for late tax payments and tax evasion.
- A state-owned development bank will be set up—operating on a commercial basis—to finance projects in the real economy. A state-owned insurance and guarantee agency will back up this activity.
- As of October the government will guarantee full payment of current wages and pensions. It will continue paying back wages and pensions, and will pressure enterprises and individuals for timely payment of wages.
- Price controls will be introduced, and the prices charged by natural monopolies, such as heating, electricity, train fares, will be frozen until January 1 (variant—until April 1). A cap on price markups will be introduced on socially significant goods at 20 percent over wholesale prices.
- Shortages of medicines and food will be alleviated by granting credits for the purchase of essential goods and providing state support to manufacturers of such goods. A previously imposed additional 3 percent import duty on essential goods will be eliminated.
- The government is expected to clear debts from state-controlled companies by allowing them to cancel out mutual debts and use barter more extensively.

Russian First Deputy Prime Minister Yuri Maslyukov said, on November 2, that Moscow plans to print 12 billion rubles by year-end to pay overdue wages to soldiers, teachers, doctors, and others in the state sector. Maslyukov said also that the Kremlin will print more money next year if international lenders don't offer the government new loans. The International Monetary Fund (IMF) said that an economic program announced by Moscow does not go far enough to secure the new loans. The IMF urged the government to come up with a realistic budget for 1999 before it would consider restarting the stalled disbursement of a $22.6 billion loan package agreed to in July. (The IMF withheld a $4.3 billion loan due in September after Russia defaulted on domestic debt and imposed a 90-day moratorium on the payment of some private foreign obligations.)

*Based on news agency reports.*
sale by the exporters of all foreign exchange revenues at market rate ought to be introduced (according to Poland’s experience, existing foreign exchange accounts could remain, but new inflows of foreign exchange should be excluded). Foreign exchange may be acquired only against import contracts and foreign exchange liabilities. In order for these measures to be effective, it is critically important to establish a rigid control of current foreign exchange transactions on the basis of reliable information flows between commercial banks and customs authorities. No obstacles to transactions with foreign exchange by private persons should be imposed.

Taking into account the extreme gravity of the current situation, it seems justifiable to consider a forced transfer of all foreign exchange deposits of Russian banks with their foreign counterparts to, say, Vneshtorgbank or Vneshekonombank (Foreign Trade Bank or Foreign Economy Bank). Foreign investments by Russian commercial banks should be forbidden, as well as their investments in foreign exchange. The government and the central bank ought to discontinue their “good-natured” attitude toward liberal foreign capital transfers. After the expiration of current extraordinary regulations imposed on August 17, it might be useful to introduce a version of Tobin’s tax to limit in- and outflows of short-term foreign speculative capital.

These measures that limit the functions of foreign exchange in the Russian economy and the inflows of foreign short-term capital will by all means exercise an effect on the rubles exchange rate. After finding its new equilibrium level, it would be important for achieving macroeconomic stabilization by reintroducing the foreign exchange corridor. This, of course, raises concern about the need to accumulate sufficient foreign exchange reserves.

Transition to economic growth

The government traditionally has linked economic growth to an increase in the volume of investments. At the same time, it is believed that under no circumstances are domestic savings, even if completely transformed into investments, sufficient to settle the country’s problems. That is why the government also strove to attract large-scale foreign capital and seconded the openness of Russia’s financial markets.

The Department of Economics, with its member research institutes at the Russian Academy of Sciences are considering a different pattern of transition to economic growth—and I share their view. According to this algorithm, initiation of economic growth in the first stage should result from increased utilization of existing industrial capacity due to stimulation of current expenditures. Such an approach is by no means directed against investments, including foreign investments. The so-called “paradox of thrift” was formulated long ago by macroeconomic theory. According to this theory, with the availability of free capacities, stimulating current consumption is more useful than stimulating savings and investments. Although under such policy the ratio of savings falls, its overall volume does not fall because total output increases as a result of better utilization of existing capacities. This is not an abstract theory. In those postcommunist countries that are now on the track of economic growth, the expansion began before the increase in investments took place.

What must be done to stimulate current consumption? A standard solution is to increase aggregate demand by loosening somewhat the fiscal or monetary policy. Its inapplicability to the modern Russian economy is obvious. The budget deficit and the acute debt crisis of the government excludes the possibility of pushing up government expenditures or radically reducing the tax burden. A simple increase in money supply would immediately undermine the fragile stability on the foreign-exchange market and quickly reduce the foreign-exchange reserves of the central bank.

What this really means is that in a two-sector, (monetary and in-kind) Russian economy the standard multiplication mechanism does not work, as it would in a genuine market economy: rubles spent by the government immediately returns, either attracted by high interest rates such as short-term Treasury bill (GKO) investment (before August 17) or through foreign-exchange investment (to the central bank). Once the economy becomes a genuine market economy, the demonetization of the real economy is eliminated, a natural balance between the return on financial instruments and production activity is established, and the functions of the foreign currency are limited to international payments, the multiplication mechanism can function again.

One of the government’s counterarguments is that no more free capacities are left that could be used efficiently in a market environment. True, under the current openness of the Russian economy nearly all our processing industry has become noncompetitive. But the country ought to make a choice: either to accept the fact that for a long time it will be deprived of significant scientific and technological potential, or to pursue a serious industrial policy, which would include the well-devised and accurately administered protection of national producers. This is of course a normative choice, but the resistance that our “reformers” have encountered in this particular field since 1992, makes me believe that the society would decide in favor of saving the national industry even at the expense of additional current costs.

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Industrial and social policy

In contrast to the executive power, the research institutes that belong to the Economic Department of the Russian Academy of Sciences have always opted for the active involvement of government in the market transformation of the economy—for the concentration in the government's hands of serious financial resources needed to pursue a well-designed industrial and social policy. This position was not the old-fashioned worshipping of the economic center, but an acknowledgment of the deep pag that existed between the actual structure of technological and industrial potential inherited from the Soviet Union and the market criteria for resource allocation. We have been sure that rationally doling-out the impact of market forces would not only reduce the number of social conflicts during the transformation period, but it would also provide an adequate place in the international division of labor for Russia, and make it possible to preserve the bulk of human and physical capital.

The research institutes mentioned above constantly warned about the strategic inadequacy of focusing production on a raw material, which would become inevitable if Russia followed dogmatically the principles of laissez-faire. We noted frequently that by refusing to participate in the process of economic and social transformation, the authorities doom themselves to playing the role of a fire brigade, rushing from one burning house to another. So many years of irrational economic policy could not have passed without grave consequences. A lot of production sectors that, after adequate restructuring, could have played an important role in a new market economy, have been destroyed, others are on the brink of disappearing. The risk of remaining for decades in the rearguard of the international community is a real possibility for Russia. Instituting radical changes in the country's economic course is the only way to resist it.

Efficient industrial policy involves the application of extremely difficult decisions. The economy has been so weakened that it has become hopeless to retain all those industries which, under other circumstances, could have been useful. The limited resources have to be concentrated in those few areas that promise a chance for Russia to fall back into the ranks of economically developed countries in the foreseeable future. A set of industrial policy instruments ought to include state procurement orders (with guaranteed payment), tax benefits and subsidies, measures aimed at supporting exports and tariffs, limiting imports in selected areas, providing incentives for the formation of competitive financial and production structures for the inflow of foreign direct investments, and so on. They will not undermine the market mechanism by reallocating resources. Setting up high tariffs to protect selected industries should come simultaneously with a firm time schedule for gradually reducing them to normal levels. Only in this way will it be possible for the respective industries to adjust to, rather than be isolated from, the world market.

Genuine market transformation of the economy coupled with the above-mentioned measures of selective structural policy, can sharpen the unemployment problem. This means that the elaboration and enactment of an efficient social safety net is one thing that will determine the success of the new economic course. Implementation of the proposed approach to economic and social policy involves the large-scale redistribution processes that can be carried out only by the executive powers—both federal and regional. That is why the need to increase significantly the government outlays (compared to the GDP), should be openly acknowledged. The rationalization of our economic system and overcoming the liquidity crisis will enable us to achieve this goal without increasing the tax burden and exceeding a budget deficit that is acceptable from a macroeconomic perspective.

Professor Nekipelov is director at the Institute for International Economic and Political Studies, Russian Academy of Sciences, Moscow, Russia.

This paper was presented at the Second Boston Seminar on Economic Globalization, Boston, 23-25 October 1998, fax 095-310-7061, E-mail: nekipelov@transecon.ru

Announcing an Anti-Crisis Program

From the Budapest-based magazine Hungarian Economy
William Davidson Institute

The Dangers of Ignoring Russian Communitarianism

by Charalambos Vlachoutsicos

There is mounting evidence that Western management consultants, trainers, and businesses operating in Russia face serious, unforeseen problems in interacting effectively with their Russian counterparts. Many of these problems stem from mutual misperceptions, which ensue from the fundamental differences in each other’s economic and political systems, infrastructures, national and business cultures, as well as managerial values and practices. The Russian communitarian value system, comprising cultural values, norms of behavior, and political as well as geopolitical patterns, proved to be an enduring feature of Russian society. It predated communism and has remained a major social force in the postcommunist era.

Its roots date back to the Kievan state, which rose in the 9th century. The essential features of the Russian communitarian value system are derived from institutions that developed in response to the focal need for survival under the adverse geographical, climatic, and economic conditions that prevailed in Kievan Russia. Kievan Russians inhabited northern land covered by great primeval forests, which concealed poor, acidic soil and a swampy terrain. Long, dark, and bitter cold winters were followed by destructive spring thaws and short summers with good weather spells of unpredictable duration. The hardships caused by scarcity have been greatly aggravated by Russians’ isolation from the outside world—either due to inaccessibility because of prohibition of foreign travel.

The biological, economic, and social survival of the individual and of the community in the medieval forest depended on extraordinary group cohesion and discipline. The members of each community needed to band together to fell the forest, till the soil, harvest the crops, and protect themselves from invaders and marauders. In the tight village commune each member being protected by family and neighbors, felt safe and secure. The culture was marked by extreme aversion to change, risk avoidance and a strong tendency to maintain stability. As a result, while the group took priority over the individual, each member was indispensable for the survival of the group. Therefore, the community had to strive to balance the interest of all its members.

Industrious, efficient village households, capable of surviving and improving their economic circumstances had strict limits set on the extent of their self-improvement. Those who were threatened by disaster, illness, or even character flaws and were, therefore, unable to survive on the land originally allocated to them by the village commune (mir), were provided for with additional means taken from the most successful. Nevertheless, each individual was indispensable for the survival of the group; therefore, the community had to strive to balance the interests of all its members. A unique and apparently contradictory combination of suppression of the individual and considerable freedom of expression evolved: members openly and uninhibitedly exercised their right to articulate their interests and opinions before decisions were made. However, once a decision had been reached, they were obliged to abide by it. Thus an apparently contradictory and unique combination of centralist and grassroots elements evolved as a central distinctive feature of Russian culture.

The Soviet system usurped age-old institutions and tried to adjust them to suit their purposes. In many important ways the Soviet system stifled the genuine aspects of the communitarian value system and, through the suppressive mechanisms of the Communist Party, eroded its grassroots participation into powerless, fake rituals. The Soviet political culture that emerged was marked by many features of the traditional communitarian value system that—although perverted—in some ways may be seen as its continuation. The workers’ collectives instituted in Soviet enterprises, by including everyone working in the enterprise, from blue-collar workers to top management, incorporated the Soviet version of the principles and practices of the Russian communitarian value system. It constitutes an example of how the Bolsheviks tried to capitalize on the strength of the traditional value system.

Belief in communism has since rapidly eroded, but the core of the original communitarian value system persists. While the effective power of the workers to initiate decisions is limited, their power to block them, especially in state and privatized enterprises, still remains decisive. Movements of the “invisible hand” of the market economy are being thwarted by the “invisible fist” of the traditional communitarian value system. Workers’ tolerance, if not support, gives top managers great political presence with central and regional governments. (Through stock accumulation, worker proxies, and other means, managers have steadily increased their share of
ownership in most of the 126,000 enterprises privatized, which account for about 70 percent of Russia's GNP. In 1997, 40 percent of shares formally belonged to employees, 18 percent formally belonged to top managers. The real distribution is estimated at 20 percent employees, 40 percent top managers.)

Soviet enterprise managers have traditionally been expected to give a high priority to the well-being of all the members of their workers' collectives, in terms of the basics of life—housing, food, education, medical care, job security, and benefits. These social expectations remain especially strong today in hundreds of medium-size towns across Russia, where economic life depends totally on the survival of only one or two big local enterprises. Workers in state and private enterprises continue to look to their top managers—not to their union leaders—as the protectors of their jobs. Workers remain loyal to the old management by supporting it with the vote of their stock, in exchange for being kept on the payroll, even part-time, and thus they continue to receive whatever fringe benefits, services, and care enterprises still provide to the members of the workers' collectives.

By ignoring the code of the traditional system, Westerners often misunderstand Russian managerial practices and decisionmaking methods. Thus Western enterprise managers usually tend to be "democratic" early on in the decision-making process of establishing targets by inviting their direct subordinates' opinions on what should be done, before establishing targets, while Russian subordinates expect a good leader to be "centralist" by establishing targets alone. On the other hand, if Western managers decide how to implement a set target, without prior consultations with their subordinates, Russians, according to their traditional decision-making process, perceive it as violating their rights, to submit their views on how a target set by the leader can best be achieved. Therefore, such decisions are very hard to finally implement.

Reputable Russian and Western economists vehemently denounce the communitarian values as old-fashioned, obsolete, and obstructive to the transformation process of the Russian economy. But their potency cannot be ignored. Whenever understood, these value do provide essential insights into attitudes and practices by workers, managers, and enterprises in present-day Russia. It comes naturally, to Russian managers and workers alike, to identify with and practice this value system and to react negatively whenever it is challenged. Acknowledging this can help Western managers devise ways in which these values can work for—not against—change. For example, structuring the management system in such a way that employees can express their opinion on implementing a given business decision, before it has been taken.

We do not claim that integrating communitarian values in the management system of Russian enterprises is the panacea for all problems. Neither do we advocate going back in history and ignoring the free market's signals and stockholders' individual profit motives as the focal indicators of the viability of enterprises. Institutions do, however, influence the incentive structure of a society and, as a consequence, political and economic institutions are the underlying determinants of economic performance. Thus efforts to introduce market-oriented managerial practices in Russia will fail, unless the traditional management system is understood, and crucial elements of the the Russian Communitarian Value System are incorporated into Western management methods.

The author is Visiting Professor at the Athens Laboratory of Business administration, Greece.


Workshop On Consumer Behavior

On July 24-25 1998, 16 distinguished marketing scholars from around the world met in Ann Arbor, Michigan to exchange views on Marketing Issues in Transitional Economies, as part of a Davidson Institute research workshop. While several papers were multicountry studies, others focused on individual countries, such as China, the Czech Republic, Hungary, Republic of Korea, Poland, Romania, Russia, and South Africa.

The papers presented spanned five major themes. The first theme was the way in which consumers in these countries were changing, as their marketing environments offered them greater choice and complexity. Russell Belk of the University of Utah discussed the apparent anomaly of low-income consumers in transition economies spending money on luxury goods. He reminded the audience that throughout history and across economies, luxury goods have always been in demand. The reasons for this demand include their symbolic ability to satisfy consumer's feelings of deservedness, their need to feel like a part of the elite, and their desire for respectability and dignity.

Jan-Benedict Steenkamp of the Catholic University of Leuven, Belgium, presented data from South Africa that examined the ways in which consumer
Presentations for ASSA’s Annual Meeting

During the forthcoming Annual Meeting of Allied Social Science Associations (January 1999) the following research fellows and faculty associates of the William Davidson Institute will present papers:

Josef C. Brada, Arizona State University, and Ali M. Kutan, Southern Illinois University, Money, Employment, Output, and Regulation: EU Membership for Transition Economies

Daniel Munich, CERGE-EI, Prague and Jan Svejnar, University of Michigan and CERGE-EI and Katherine Terrell, University of Michigan, Wage Determination Before and During the Transition in the Czech Republic

Jan van Ours, University of Tilburg and Martina Lubyova, Slovak Academy of Sciences, Active Labor Market Policies and the Transition Rate from Unemployment into Regular Jobs in Slovakia

Mark Foley, University of North Carolina, The Transition from Work to Retirement under Economic Uncertainty in Russia

Enrico Perotti, University of Amsterdam and Stanislav Gelfer, RECEP, Investment and Financing in Russian Financial-Industrial Groups

Anna Meyendorff, William Davidson Institute, Credit Allocation in Russia: The Role of Financial-Industrial Groups

Philippe Aghion, University College London and Steven Fries, European Bank for Reconstruction and Development, Bank Bailout Policy

Jan Svejnar, University of Michigan and CERGE-EI and Frans Spinnewyn, Catholic University of Leuven, Unionized Firms in Transition Economies

Gerard Roland, Universite Libre de Bruxelles, Institutions, Law Enforcement, and Transition

John P. Bonin, Wesleyan University and Istvan Abel, Budapest University and National Bank of Hungary, Restructuring in a Hurry: Hungarian Companies Attempt to Maintain Market Share

Annette N. Brown, Western Michigan University and J. David Brown, Stockholm Institute of Transition Economics, The Evolution of Market Structure in Russia: Implications for the Emergence of Competition

Daniel Berkowitz, University of Pittsburgh and David N. DeJong, Internal Borders

Saul Estrin, London Business School, Privatization and Corporate Governance in Ukraine

John Earle, Stanford University, Stockholm Institute of Transition Economies, The Political Economy of Mass Privatization

Jan Svejnar, University of Michigan and CERGE-EI, Prague, Currency and Financial Crises in Eastern Europe and the Former Soviet Republics

"values priorities" differ by segment; the factors (such as gender and age) that explain these differences, and the consequences of these differences on consumption behavior. (This paper was coauthored by Steven Burgess of the University of Witswatersrand in South Africa.) Segment differences were also the subject of Bernd Schmitt's paper on consumer segments in China (Professor Schmitt holds appointments at Columbia University in New York and at the China Europe International Business School in Shanghai). David Tse and two coauthors from the City University of Hong Kong discussed research on generational differences over family purchase decisions among women in mainland China and their modes of resolving disagreements.

Three papers focused on measuring and improving the extent to which firms in transition economies possessed a marketing orientation, necessary for survival and success in the more competitive postliberalization economies. Ron Savitt of the University of Vermont reported on his study of 76 enterprises in the Czech Republic. His conclusion was that not enough progress had been made, despite a lot of lip service to the concept. Two other papers in this stream focused on measurement issues. John Farley of Dartmouth and Rohit Deshpande of Harvard reported success in the valid and reliable measurement of market orientation among firms in several emerging and transition economies, while Patricia Huddleston and Linda Good found similarly satisfactory results in their study of retail firms in Poland.

The third theme was Branding Challenges for local firms in transition economies. The defensive perspective of ways in which they could fight global entrants into their local markets given their own severely limited resources, was discussed by Erich Joachimsthaler of the University of Virginia, drawing from his research on European firms. Rajeev Batra of the University of Michigan took the offensive perspective and reported on his study of...
brand-building challenges faced by firms in the Republic of Korea as they tried to expand in Western markets.

Theme four was the evolution of distribution systems. Carmen Balan of the Academy of Sciences in Bucharest presented details of how the Romanian distribution system was evolving and the challenges that it still faced. Jim Gentry and Debra Dahab of the University of Nebraska discussed the continuing importance of relationships in the Hungarian distribution system. Louisa Ha of the Gallup Organization and Mrinal Ghosh of the University of Michigan presented exploratory data from China on that country's continuing problems with distribution arrangements, and how local companies and multinational corporations were coping with them.

The Strategic Issues theme included ways in which to choose which markets to enter and decisions on timing and mode of entry. Lalita and Ajay Manrai of the University of Delaware (with Dana-Nicoleta Lascu of Richmond) presented data comparing the market entry attractiveness of 18 Central and Eastern European economies, while Yigang Pan from the City University of Hong Kong reported on analyses from China showing that early entrants tended to do better, often using equity joint venture arrangements. Several collaborative research projects are likely to emerge from the conference, and an edited volume of the presented papers is planned.

Information: Professor Rajeev Batra. Email: rajeevba@umich.edu

Recent Papers of the William Davidson Institute

Copies of the working papers are also available by contacting Sharon Nakpairat, Research Manager, 701 Tappan Street, 9th Floor, Ann Arbor, Michigan 48109-1234, United States, tel. 313-763-5020, fax 313-763-5850, E-mail: sharonch@umich.edu; or davidson.institute@um.cc.umich.edu; Internet: http://wwwwdi.bus.umich.edu. Following is a list of some of the Institute's recent working papers.


Rise and Fall of the Hainan Development Bank
by Chi Fulin

The Hainan Development Bank is the first bank in China to close down in 50 years. It has attracted worldwide attention, especially because of Asia's severe financial crisis.

The Formative Years

Before Hainan was declared a province and granted it special economic zone status in April 1988, only two nonbanking financial institutions were operating here, on China's southernmost island. By the end of 1992, 1,000 branch offices of the 5 big commercial banks, 24 trust companies, and more than 30 urban credit cooperatives, and several hundred rural credit unions, foreign banks, insurance companies and securities agencies were located in Hainan—altogether 2,068 financial institutions in a region with a population of 7 million.

In 1993 a number of trust companies came close to insolvency, along with the drastic cooling of the once-booming property market. Seeking a way out, Hainan's provincial government requested and received the permission of the Peoples' Bank of China (the central bank) to establish the Hainan Development Bank (HDB) by merging the successful Hainan Funan Trust and Investment Company with four ailing trust companies (Huaxia, Jiya, Shuxin, and Zheqiong). In 1995, HDB started operations as one of the first local commercial banks, or, as the media put it, "one of the few purely profit-driven banks" in China. Its purpose was to finance the development of the province. Hainan's provincial government put in 320 million renminbi and became a major stockholder, holding a 30 percent stake. Altogether, 47 shareholders bought up stocks for a total equity value of 1.7 billion renminbi.

Expansion came easily at first. The bank soon had offices in six mainland cities outside Hainan, including a full-service branch in southern Guangzhou and 3,000 staff members. In 1996 it made pretax profits of 125 million renminbi ($15 million) and boasted deposits of 4.1 billion renminbi. Despite the expansion, the bank's loan quality has not been very good. The bank's 1995 annual report acknowledged that some loans had to be rescheduled.

But it was a financial crisis involving Hainan province's 33 credit unions that pushed HDB over the brink and closer to insolvency. As elsewhere in China—as pointed out by Bruce Gilley, Hong Kong correspondent for the Far Eastern Economic Review, in a recent article, titled "Breaking the Bank"—credit unions took a lot of business from banks beginning in the late 1980s by offering better service and high (often illegally so) interest rates for savers. In Hainan credit unions sat on deposits worth 33 billion renminbi, or 51 percent of all deposits in the province at the end of 1996.

The Hainan provincial government instructed the Development Bank, with the approval of the central bank, to take over 28 of the 33 credit unions. The others were closed. The 28 credit unions chosen had total assets worth 13.7 billion renminbi (almost all loans) against total liabilities of 14.2 billion renminbi. The central bank allocated 4 billion renminbi to cover the bad loans of the credit unions, or about a third of the total loans. But about two-thirds of the loans were nonperforming, leaving another 4 billion renminbi shortfall on the Hainan bank's doorstep. Before the takeover HDB's books showed assets of 11 billion renminbi, about half of its loans. These had been funded with deposits of 4 billion renminbi as well as bond issues and shareholder funds.

The forced merger came at the worst time. The Asian financial crisis was beginning to release its sweeping forces. Frightened depositors started to withdraw cash from the banks. HDB not only failed to pull the credit unions back from the brink, but with small cash reserves, it also sank into a severe payment crisis. Early this year HDB tried to float bonds on the capital market—there were no buyers. In desperation HDB tried to reclaim large amounts of debt for HDB. It brought more than 400 lawsuits to the court. These last-minute measures proved futile. By the time the closure was finally announced on June 21, no one in Haikou was surprised. HDB was put under the trusteeship of the Industrial and Commercial Bank of China, which has to pay out both individual deposit holders and overseas creditors of the bankrupt HDB. Negotiations for a final settlement with institutional and enterprise depositors, who provided the bulk of HDB's resources, including the amount of interest they should receive, are still continuing.

Reasons for Collapse

In retrospect, several factors accounted for the closure of HDB:

- The three-year existence of the Hainan Development Bank (1995-98) coincided with the lowest annual economic growth of the Hainan Special Economic Zone in this decade. The province became a laggard on the national ratings list. While the national savings for the first half of this year—compared with the same pe-
period last year—jumped by more than 15 percent, in Hainan savings nudged upward by a mere 0.13 percent, and the value of outstanding loans increased by 0.39 percent—also compared to the same period last year. Local government officials, tend to blame the closure of HDB on the bursting of the “bubble economy.” The bubble economy did play a role, especially as most trust companies and credit-cooperatives—either merged or taken over by HDB—were established to finance investments in the fast-growing (and later) “bust-going” property market. “Once the property boom ended, the accumulated problems of many years burst into the open. Many financial institutions got caught up in the property craze in Hainan, resulting in illegal operations and loss of control,” according to the People’s Daily. However, this is only part of the story.

In keen competition with other banks, HDB had to offer high interest rates and hidden commissions to attract savings deposits. During its expansion drive it accumulated a large stock of bad loans that eventually undermined its solvency. Even if HDB’s performance had been better, insufficient capital and questionable financial assets of the 28 merged credit cooperatives eventually would have shaken its financial posi-

### TICs in China’s Financial System

When state-owned Guangzhou Shipyard International parked some of its cash in fixed deposits at a handful of China’s trust and investment corporations last year, little did it know that it would have to sue to get it all back. Since the last of its deposits came due in July, $19.2 million remains outstanding—about 10 percent of the company’s net assets. Guangzhou Shipyard blames the high-flying trust and investment corporations, or “TICs,” for bad investment decisions and poor management.

TICs are the most important of China’s so-called nonbank financial institutions, which offer alternative financing and other services that state banks can’t provide. But most of the country’s 243 TICs are faltering. (Of the total, roughly 100 hold licences to raise capital overseas, these are the international TICs, or ITICs.) “According to international standards, the majority are bankrupt in terms of their operations and debt-to-equity ratios,” points out an executive at a Zhejiang-based tic who declined to be identified. The major barometer is the impact that collapsing TICs will have on the state banks.

TICs represent only 3.3 percent of all assets held by the country’s financial institutions, but their failure would be a tremendous burden on the banks, which are unlikely to be reimbursed for taking on the debts of these ailing institutions. China’s state banks are obliged to come to the rescue every time nonbank financial intermediaries run into trouble. That, in turn, perpetuates a moral hazard, economists argue, encouraging risky lending and investments.

Problems started to surface in the 1990s when TICs reduced their traditional lending and investment activities and increased their exposure to property development and stock brokerage. Chen Yulu, a professor at Beijing’s People’s University, claims that about half of the TICs’ total assets have been invested in real estate. “These TICs were born as a kind of hidden reserve for provincial governments,” adds an official at a tic in one of China’s inland provinces. “They were forced by local governments to make investments in local projects or give loans to local enterprises. They also lacked self-discipline and monitoring by the central bank.”

In addition to moving into riskier activities, most TICs have increased their off-balance-sheet exposure, mostly in the form of loan guarantees. Some have created huge unhedged foreign-exchange exposures. And while much of their lending is denominated in foreign currencies, most of the borrowers have insignificant foreign exchange revenues.

For their part, Guangzhou Shipyard and other state-owned companies listed on the Hong Kong stock exchange are seeking redress through the courts. In July Zhenhai Refining & Chemical launched legal proceedings against the China Orient Trust & Investment Corporation. in Beijing. When its $20 million deposit came due on July 1, it was told that the director of the capital department had “disappeared” and that a “criminal incident” was under investigation.

According to Wang Songqi, vice director of the Finance Research Centre at the Chinese Academy of Social Sciences in Beijing, the solution is to make ITICs and TICs private institutions in charge of their own lending and investment decisions as well as their debt. “That would avoid the current situation where once an ailing TIC is bankrupt, the buck is passed to another state-owned financial institution or commercial bank,” Songqi said. “But changing that mind set is going to take at least five years.”

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Excerpted from Trish Saywell’s recent article, “Tic Fever: China’s Shaky Trust and Investment Houses Start to Fall,” Far Eastern Economic Review, October 22.
tion. Surprisingly enough, these problems for a long time have escaped the attention of individuals and departments in charge. Some clients had easy access to multimillion-renminbi loans. For instance, a private company in Hainan received a 1.35 billion renminbi loan from three credit cooperatives taken over by HDB. Soon thereafter, the company applied for bankruptcy. Before HDB’s closure, the central bank shifted more than 3 billion renminbi as provisional loans to HDB, strictly for cashing in savings deposits. However, the majority of it was misappropriated for other purposes. This chaotic situation undoubtedly has been associated with corruption of one kind or another.

Lessons Learned

Since 1997 China’s central government—while accelerating the country’s financial system reform—consented to and supported the locally established commercial banks. The sad fate of HDB shows, however, that things can go sour if a shareholder—be it a principal investor, such as the local government—goes beyond its designated role and intervenes arbitrarily in important organizational matters and decisions—above the head of the bank’s management—what projects should be given loans. If they want to succeed in market competition, banks need a governance structure that corresponds to their joint stock company statute.

HDB was established by the patching together of assorted banks, in order to help the poorly performing ones. As the bank started to get out of difficulties, it had to take over 28 tottering credit unions, and this sealed its fate. It was like rubbing salt in an open wound. Forcing viable banks to merge with the weak or the bankrupt can push otherwise healthy financial institutions into bankruptcy and start an unwanted chain reaction.

The central bank, through its local branches, should supervise and regulate local financial institutions and, at the same time if necessary, prevent local government from interfering in the administrative affairs of the local bank. In this respect we should specify two major problems:

—The unequal relationship between the central bank’s local branch and the local authorities. In most cases, local branches of the central bank can hardly veto decisions of the local government, some even pursue the local government’s agenda. In Hainan supervision and regulation of HDB by the central bank’s local branch had been relatively weak throughout the now-closed bank’s three years of existence.

—Local branches of the central bank lack the resources for effective probing, monitoring, and supervision of its operations. At present, there are more than 200,000 financial institutions in China that employ about 2.4 million people, while the supervisory and regulatory staff of the central bank and its branches only number 10,000. Thus although central bank branches at the provincial level are authorized to supervise and regulate local financial institutions and report to the main office of the central bank, the branches lack the effective means, staff, and equipment to do so. Much of the supervision is based on reports of the financial institutions, some of which contain “nicely packaged” information, playing down the difficulties, rendering a problem-free, reassuring picture.

After closing down the HDB, financial authorities recently withdrew the operating license of the Guangdong International Trust & Investment Corporation (GITIC), the nation’s second-largest trust and investment company. GITIC was set up in 1980 to manage investments on behalf of Guangdong province, the fast-developing region that borders Hong Kong. Its investments included the Guangzhou-Shantou railway, power plants in Dongguan, and the Shenzhen Science and Technology Park.

In recent years its heavy exposure to real estate in southern China went sour. GITIC’s $2.4 billion in outstanding liabilities have been transferred to the People’s Bank of China, which promises to repay principal and interest in full—but only on legal debts. The People’s Bank of China was drawing up new rules to standardize the procedures used to close GITIC.

The author is executive deputy director of the Haikou-based China Institute for Reform and Development (CIRD), 57 Renmin Ave., Haikou, Hainan, 570208, China, tel. 86-898-625-8793, fax 86-898-625-8777, E-mail: cird2@public.hkhi.cn

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A Hungarian Action-Thriller

"Hang in there Oscar, soon we will reach the tax free zone."

From the Hungarian magazine Hocipo.
Defining the Post-Washington Consensus on Monetary Policy

by Kurt Schuler

Two articles in the June 1998 issue of Transition discussed the emerging "post-Washington consensus" on economic policy recommendations, especially as it applies to former socialist economies. Notably absent was any reexamination of monetary policy. Since the Washington consensus on monetary policy has never been articulated as John Williamson did for the overall Washington consensus some years ago, the first step in reexamination is articulation. Judging from the policies that the Washington institutions (IMF, World Bank, Inter-American Development Bank, U.S. Treasury, and USAID) have recommended over the past decade, the following propositions define the Washington consensus on monetary policy.

Goals of monetary policy: On the domestic side, inflation should be in the low-to mid-single digits. The central bank law should contain a clear commitment to maintaining low inflation as the primary goal of the central bank. An important secondary goal is to provide a safety net for the financial system by acting as a lender of last resort. On the international side, the real exchange rate should not diverge too far from fundamentals by becoming greatly over- or undervalued; note that, unlike the other goals, this rarely appears explicitly in central bank laws. These goals may conflict at times.

Conduct of monetary policy: For larger countries, the preferred target is inflation rather than the exchange rate or some measure of the money supply, but even for them the needs of exchange-rate management may sometimes trump the inflation target. For smaller countries, targeting the exchange rate may be more technically feasible than targeting inflation. For all but the smallest countries, the current consensus—unlike the Bretton-Woods era consensus—is that the exchange rate should be somewhat flexible, though not necessarily a floating rate.

Role of monetary policy: An appropriately managed monetary policy can offset financial shocks by providing a safety net for the financial system. Such a policy can also offset some unfavorable real shocks by reducing the suddenness with which nominal prices need to change. Low inflation helps to make long-run economic growth less volatile.

Monetary authority: In most independent countries the monetary authority should be a central bank with a high degree of independence from the rest of the government, because that provides the greatest potential to manage monetary policy free of political interference. Central bank independence is desirable in developing countries, even though research so far shows no clear link with inflation, as seems to exist for industrial countries.

Monetary reform: Ordinarily (and the Asian currency crisis is an exception), countries that get into monetary trouble generally do so because they accumulate government budget deficits or quasi-fiscal deficits, thus pressure their central banks to finance the deficits through inflation. Cutting deficits is thus a precondition for successful monetary reform. There are many potential sources of deficits, such as bank bailouts, food subsidies, and grants to loss-making state enterprises. Each is a potential a precondition of monetary reform. To make the real exchange rate competitive, a large initial devaluation generally is necessary. Large subsequent devaluations should be resisted, even at the price of high real interest rates, otherwise the central bank will not achieve credibility. In the early stages of monetary reform a less flexible exchange rate may be appropriate; later, the rate can become more flexible. Large current-account deficits signal that the currency may be overvalued.

For countries with moderate inflation of, say, 6 percent to 20 percent or perhaps even 40 percent a year, quickly reducing inflation to low single digits may cause an unnecessarily large loss of output in the short term. The higher the rate of inflation, the lower the loss of output from quickly reducing inflation. For countries suffering from hyperinflation, quickly reducing inflation often stimulates output.

The financial system: The main tool for promoting sound banking is prudential regulation. The threat of contagion from systemwide bank runs is high and necessitates a lender of last resort. Opening the financial system to extensive foreign competition is desirable, but not a high priority.

Like the overall Washington consensus, the Washington consensus on monetary policy is a series of measures usually
recommended by Washington institutions rather than a list they adhere to rigidly in all circumstances. But, in light of the actual performance of monetary policy in former socialist economies, it is strange that no post-Washington consensus has begun to emerge as it has in privatization, social services, and other areas. The Asian currency crisis and its worldwide effects are making people think more favorably about capital controls. But permanent capital controls could fit into the consensus with only small modifications of the other elements. After all, Keynes favored permanent capital controls, and the IMF Articles of Agreement are worded to allow them.

Almost all former socialist economies have been receiving aid or advice on monetary policy from the Washington institutions for at least five years. Many countries have not followed the advice consistently, but that in itself is telling. As an indication of the effectiveness of advice from Washington, consider the change in exchange rates during the past five years against the U.S. dollar, or whatever other currency is used as the anchor. I have selected a period of five years because by mid-1993 the former socialist economies had enough time to resolve the exchange-rate problems they inherited from socialism. Since then, their problems have been of their own making. Besides the exchange rate, one could look at inflation rates, interest rates, or convertibility, but they would tell a similar story. The exchange rate is a good shorthand view of the overall performance of monetary policy.

The only former socialist economies that have maintained stable exchange rates during the past five years are Bosnia, Estonia, Latvia, and Slovakia. Bosnia has maintained a fixed exchange rate to the German mark, and has recently solidified the rate by establishing a currency-board-style system. Estonia has had a currency-board-style system since it replaced the Russian ruble with its own currency in 1992. Lithuania had a currency-board-style system from 1994 to 1997, and Bulgaria has had one since 1997. Unlike the central banking systems that preceded them, both Lithuania and Bulgaria have maintained stable exchange rates. Latvia has a central bank that holds roughly 100 percent foreign reserve backing for the monetary base and maintains a stable exchange rate with the special drawing rights (SDR). Slovakia inherited a tradition of relatively tight monetary policy from the Czechoslovak Central bank, which it has continued.

Monetary policy in other former socialist economies has ranged from mildly disappointing (Czech Republic) to wretched (Belarus, Ukraine). Even those countries hailed a few years ago for having stabilized their currencies, such as the Czech Republic and Russia, have since experienced currency crises that have required either devaluation or extensive foreign aid.

The wide use of the U.S. dollar and the German mark as stores of value and media of exchange in most former socialist economies is another indication of poor monetary policy. The value of trade in dollars purely within Russia was estimated to be twice the value of trade in rubles even before the latest ruble crisis.

In the wide sense, monetary policy also includes bank regulation. In most former socialist economies the banking system remains fragile and rather backward. Governments restrict foreign competition to protect market share for locally owned banks. By doing so, however, they slow the pace of innovation and deny depositors the stability that banks with international branches offer. Governments have chosen to rescue rather than close many insolvent banks. Though there has been no systematic study on the question, the high cost of many bank rescues suggests that closing banks is more efficient than rescuing them.

The Washington institutions have spent large amounts of time, energy, and money trying to improve monetary policy in former socialist economies. Despite it all, in most cases, monetary policy in the recipient countries has been much worse than it would have been by simply importing sound monetary performance through currency boards or dollarization, and importing a good banking system by allowing the world's leading banks to buy or compete freely with domestic banks. To me, this suggests that a post-Washington consensus on monetary policy in former socialist economies and other developing countries should contain the following propositions:

**Role of monetary policy:** A managed monetary policy is more often a cause of shocks than a buffer, especially in former socialist economies and other developing countries. At least for such countries, the most appropriate monetary policy is a completely automatic one that leaves no room for local management.

**Monetary authority:** The monetary authority should be an orthodox currency board or, as in the case of a dollarized system, no monetary authority at all.

**Goals of monetary policy:** Monetary policy should have only one goal: to maintain full convertibility at a truly fixed exchange rate with a sound major currency, generally the U.S. dollar or German mark.

**Conduct of monetary policy:** A truly fixed exchange rate provided by a currency board or dollarization is sustainable indefinitely. The automatic character of monetary policy means that inflation, interest rates, the real exchange rate, and so on are determined by market
forces through international arbitrage without centralized monetary management. The currency should be made fully convertible immediately.

Monetary reform: Generally, central banking rather than bad fiscal policy is what gets countries into monetary trouble. Currency boards or dollarized systems cannot finance fiscal or quasi-fiscal deficits, so they tend to force fiscal reform, rather than requiring it as a precondition for successful monetary reform. A large initial devaluation of the exchange rate may not always be necessary. There should be no attempt to defend the currency with high interest rates; international arbitrage will tend to push rates toward the levels of the anchor currency. Under currency boards or dollarization, large current-account deficits are perfectly acceptable and do not signal possible overvaluation relative to the anchor currency.

Even in countries with moderate inflation there may be no loss of output in the short term from establishing currency boards or dollarization quickly, because they have more credibility than central banking in guaranteeing low inflation.

The financial system: A lender of last resort creates more problems than it solves. Closing insolvent banks is preferable to rescuing them with government funds. The financial system should be fully open to foreign competition; “internationalization” makes the financial system more robust and is more effective than prudential supervision at improving the average quality of domestically owned banks.

Kurt Schuler, a monetary consultant, is the author of Should Developing Countries Have Central banks? (London: Institute of Economic Affairs, 1996).

CEE Customs and the Year 2000 Bug—Ready for the Millennium?

In recent issues of Transition, we highlighted a number of problems that businesses face in trying to get consignments through customs in Central and Eastern Europe: lack of adequate communication between customs administration and the business world, sometimes overly rigid interpretation of the rules, a shortage of resources, and related to this, a lack of information technology systems capable of matching the needs of businesses. The challenge customs authorities face is not only to upgrade information technology systems, but to prepare for the “millennium” or “year 2000” (Y2K) bug.

The status of customs information technology capabilities around Central and Eastern Europe and the CIS is very mixed. Some countries have developed fully integrated systems and allow electronic data exchange. Others have absolutely no automation at all. Everything is done manually, which makes the customs clearance process very time-consuming and costly. (At the same time, these are the customs offices that are not worried about “year 00”).

However, very few countries have invested sufficiently in customs information technology. Many customs declaration systems have been developed with little regard for business requirements and future needs of the EU accession, the Y2K problem, and changes in computer technology, including new computer languages. As a result, in most Central and Eastern European countries customs information technology systems vary. They perform various tasks without the ability to share or transmit data. In some countries DHL is often asked to manually duplicate the electronic clearance process by producing hard copy declarations. This brings little benefit to either the customs authorities involved or to companies such as ours that clear the goods.

Earlier this year The Gartner Group surveyed countries around the world to assess their computer preparedness for the millennium. The survey graded countries from 0 (no action taken at all) to 5 (completion of work on all systems). The Central and Eastern European states and Russia were assessed at level 1 (basic recognition of the problem and the need for action), while most of the CIS, outside of Russia, were assessed at 0.

One reason for the lack of action so far is, of course, cost. In August, Alexander Krupnov, chairman of the Russian state communications commission, estimated that it could cost Russia $500 million to fix the problem. Another reason for lack of action is simply a perception that the problem will go away [This attitude is not restricted to Transition countries, see box. The editor.]

Although DHL is investing $25 million to make sure its systems are Y2K-compliant, it is vital that the systems used by customs authorities are able to function come January 1, 2000 (or earlier, in the case of systems that forecast months ahead). If timely solutions aren’t found,
the implications to the economies of Central and Eastern Europe, are enormous. Business Week has estimated that the Y2K problem will cut half a percentage point off their growth in 2000 and 2001.

What is being done to help customs authorities in Central and Eastern Europe develop information systems that both can meet the needs of foreign investors and avoid any year 2000 problems? Countries wishing to join the European Union are under pressure from the European Commission to deliver electronic customs declaration systems that are Y2K-compliant, as detailed in their Blueprint for Accession document (see Transition, June 1998). Funding has been provided via the PHARE program, with mixed results.

The United Nations Conference for Trade and Development (UNCTAD) worked out a program—Automated System for Customs Data (Ayscuda)—to computerize and simplify the customs process. The Ayscuda system takes into account all international codes and standards relevant to customs processing as established by International Standards Organization (ISO), the World Customs Organization, and the United Nations. It can be configured to suit individual customs regimes, national tariffs and customs regulations, and legislation. The express industry offered UNCTAD its help to accelerate application of the package. Nevertheless, uptake has been slow so far, although customs authorities will have better opportunities to control exchange and commodity duty networks, the BIOS in PCs, and even the date-driven chips that comprise embedded systems.

What's it all going to cost? Some estimates put $600 billion worldwide as the cost of repairing applications, networks, embedded systems, and so on. While the cost of repairs will be high, perhaps the most alarming threat is the cost of litigation. The American Bar Association has projected an additional $700 billion for litigation associated with the year 2000 problem. These lawsuits will be filed by clients whose finances or investments have been damaged, and by shareholders whose companies suffer from not making the transition.

The current state of readiness is troublesome. Anywhere from 40 to 60 percent of all U.S. companies have yet to begin addressing the problem. That's a startling statistic, but one dwarfed by surveys coming out of Europe and Asia where the century date conversion has barely registered on the spreadsheets of countries dealing with challenges ranging from monetary union to economic collapse.

The World Bank realized that there is a problem at hand. Its Information for Development (info Dev) is providing grants to transition economies, to address the problem, on a first-come-first serve basis. The grant can range from $100,000 (for the development of national plans) to $500,000 (for implementation of the Y2K adjustment). (See also the Bank's Web site: http://www.worldbank.org/y2k.)

(Contributions of Robert K. S. Hoge from the World Bank's Information Solution Group and Miroslav Frick from the Budapest Regional Office, are appreciated.)
rates, and offer automated clearance. Frequently authorities adopt only selected components of the UNCTAD program, reducing it to little more than an electronic typewriter.

DHL is ready to provide assistance. The state customs office at the Warsaw airport, for example, (together with our company) is testing new software that will speed up the customs clearance process considerably. Once this system goes "live" later this year, DHL's customs agents will be able to transfer all shipment data to the customs office with a simple click of the mouse (a similar system already exists in the Czech Republic). The customs officer will be able to process the documentation and send it back to DHL with another click.

The express delivery industry has many years of practical experience in the development of automated customs declaration systems throughout the world. Customs authorities should be encouraged to work in partnership with the industry to implement state-of-the-art systems that are capable of handling businesses needs. Besides, the Y2K problem has serious implications and customs authorities are urged to act now if they have not already.

The author is DHL's director for Central and Eastern Europe and the CIS.

DHL is both the leading air express carrier in the CIS and the largest importer (measured in transactions) into Central and Eastern Europe as a whole. DHL is interested in hearing any comments from Transition readers about customs procedures in the transition economies. Please contact Dirk Singer, E-mail: dirks@redconsultancy.com, tel. 44-171-485-7700.

Readers Forum

The Crisis and Its Roots—Ruble Collapse Revisited

by Evan Scott

Increasingly, the International Monetary Fund (IMF) seems to be targeting structural adjustment criteria rather than stabilization criteria. This seemed to be the case in Indonesia, for example, where the IMF program appeared to target the corrupt dealings of the Suharto regime by advocating increased transparency in government contracting. Yet experts in this field tend to agree that establishing a Western-style rule of law in Indonesia could take a generation or more. How then, could these structural adjustments have been considered effective for an economic stabilization program?

The lesson of the debacle that followed in Indonesia could be that instruments must be matched to objectives, including the time frame envisioned for the objectives to be achieved. Unfortunately, this lesson had not been absorbed by IMF staff by the time the last IMF loan to Russia was approved last summer. The record of the Russian debacle is as follows.

In the first two weeks of August 1998 it was already clear that Russian central banking authorities could not prevent a collapse of the ruble. And this was just weeks into a $4.8 billion IMF program, part of a $22.6 billion package of loans whose main goal was to support the ruble, come what may. On August 17 the Russian government devalued the ruble and, in a potentially more damaging move, mandated a general default on Russian debt.

The central bank Governor at the time, Sergei Dubinin, disclosed that from July 20 until the ruble's collapse, the central bank had actually spent up to $3.8 billion to defend the currency, while the Finance Ministry had used $1 billion to redeem short-term government debt. What this means is that the IMF loan was effectively expended in a fortnight, as the Russians tried to prop up the ruble by spending more than $1 billion a week. But there's more. Former Deputy Prime Minister Nemtsov alleged that during this period he tried to get the prime minister to consider a devaluation, only to be told that this was impossible. Why? "Because the IMF opposed it," said Kiryenko, according to Nemtsov, who revealed this, after President Yeltsin fired the entire government.

How could this debacle happen? Indeed, why was the IMF trying to prop up the ruble instead of quietly counseling a more flexible exchange rate policy? It wasn't as if there had not been warnings that this policy was folly on an immense scale. In fact, my own article in the August issue of Transition, "Who Believes the Ruble Will Not Be Devalued?" argued the following: Why have officials of international institutions and Western governments tied the future of reform in Russia to an overvalued exchange rate? Trying to maintain an artificially high exchange rate will only deplete the country's remaining foreign reserves, use up its lines of credit to international financial institutions, and force it to stifle recovery with an exorbitant interest rate.

The antecedents to the ruble debacle, also covered in that article, are well known. Russia had achieved a kind of stability on the back of its oil exports,
which it utilized, in combination with the nonpayment of government wages and pensions, to compensate for its failure to collect taxes. But when the price of oil fell by half, its oil income dropped.

When an unforeseen but apparently permanent national income shock like this occurs the prudent response is to reduce the price of one's exports and increase the price of imports to regain stability. The way to do this is to let the currency depreciate, withstand the upward adjustment of import prices that will follow by standing fast against increased wage demands and pleas for more subsidies, and just ride it out.

In fact, this response is what the textbook IMF approach would indicate. IMF loans are supposed to help a country ride out the stabilization period by providing the foreign exchange it needs for essential imports until the depreciation causes exports to pick up. It is true that a depreciation makes it harder for the country to repay its foreign loans until its exports have recovered. But that is also what IMF loans are supposed to help with, by providing short-term liquidity to finance the increased cost of servicing foreign debts until export revenues pick up.

Instead, somehow IMF staff were persuaded to tie short-term stabilization goals to commitments to implement medium-term structural adjustment measures. With oil and gas revenues having severely declined, and with the government having already borrowed well beyond its capacity, immediate reform of the tax system, including reform of the tax collection institutions, became a prerequisite for the success of the IMF-supported stabilization program.

Consider a scenario in which a succession of Russian prime ministers, dating back to the earliest days following the collapse of the Soviet Union, had failed to achieve tax reform over the opposition of the communist-dominated Duma, and that achieving a timely outcome of this longstanding struggle was inherently outside the control of central banking authorities responsible for maintaining the value of the ruble. How much better it would have been if the IMF and the Western government officials who were interested in maintaining Russian economic stability had counseled from the beginning that propping up the ruble would not fly, and the $23 billion IMF-backed financial package ought to be used to bridge the government's debt-payment obligations in the short-term until those obligations could be restructured.

The author is an international economist, based in Washington, D.C.

Institutions Count More than Liberalization Speed
by Vladimir Popov

The conventional wisdom suggests that differences in economic performance are associated mostly with "good and bad" policies—in particular, with the progress in liberalization and macroeconomic stabilization: Countries that are more successful than others in introducing market reforms and bringing down inflation are believed to have better chances to limit the reduction of output and to quickly recover from the transformational recession. In general this may well be true, but the devil is in the details, which often do not fit into the generalization and make the whole explanation look trivial. In Russia, despite the high degree of liberalization and three years of macroeconomic stability (until the August crisis), the economic performance was poor and ended up in a spectacular crash.

The champions of liberalization and stabilization in the Eastern Europe-Central Asia region are the Baltic states (their so-called ABRADF cumulative liberalization index reach 2.4-2.9 by 1995), whereas Uzbekistan (with an index of 1.1) commonly is perceived to be one of the worst procrastinators. However, in Uzbekistan the reduction of output in 1990-95 totaled only 18 percent and the economy started to grow again in 1996, while in the Baltics output fell in the early 1990s by 36-60 percent and even in 1996, two years after the bottom of the recession was reached, it was still 31-58 percent below the prerecession maximum.

Overall, attempts to link differences in output changes during transition to the cumulative liberalization index and macro stabilization (rates of inflation) have not yielded any impressive results. Decline in output is a supply-side phenomenon and is the result of a structural adjustment process that rectifies distortions of the centrally planned economy, including restructuring an obsolete militarized industry, strengthening the weak service sector, and developing a healthy trade pattern.

The decline of noncompetetive enterprises and industries is not followed instantly by an expansion of competitive industries and enterprises, due to barriers to capital and labor flows, including the poorly developed banking systems and securities markets, uncertain property rights, the lack of easily enforceable and commonly accepted bankruptcy and liquidation procedures, the underdevelopment of land markets, housing markets, and labor market infrastructure.
While initial conditions are important, government policy does affect performance. Policy measures are required to preserve or create strong and efficient institutions that facilitate the market economy. In most CIS and Balkan countries the collapse of institutions is apparent in the dramatic expansion of the shadow economy; the decline of government revenues as a proportion of GDP; the inability of the state to deliver basic public goods and appropriate regulatory framework; the accumulation of tax, trade, wage, and bank arrears; the demonetization, "dollarization," and "barterization," of the economy; and the decline of bank financing as a proportion of GDP. It is also demonstrated through the poor enforcement of property rights, the disregard of contractual obligations, the general breakdown of law and order and increased crime rates.

According to a recently conducted global survey that questioned firms in 69 countries about their trust in state institutions, firms in the Commonwealth of Independent States (CIS) had the lowest credibility, below that of Sub-Saharan Africa (1997 World Development Report, The State in A Changing World). Especially striking was the gap between Central and Eastern Europe and the CIS.

The share of state revenues in GDP can well indicate the institutional capacity of the state—the financial strength of the government. Though much has been said about "big government" and too high taxes in former socialist countries, by now it is rather obvious that the downsizing of the government that occurred in most CIS states during transition led to the collapse of the state institutions.

There is enough evidence to show that differing performances during transition, after factoring in initial conditions and external environment, mostly depend on the strength of institutions and not so much on the progress in liberalization per se.

The author is at the Academy of National Economy in Moscow and is a visiting professor at Queen’s University, Canada. His forthcoming articles: "Investment in Transition Economies: Factors of Change and Implication for Performance," Journal of East-West Business and "Will the Russian Economy Get on a Fast Growth Track," Communist Economies & Economic Transformation, E-mail address: popovv@gsilver.queensu.ca

Causes and Lessons of the Stock Market Crisis by Sándor Kopátsy and György Matolcsy

The present stock market crisis was caused primarily by the monetary surplus that has accumulated in the global economy. The supply of investment funds significantly exceeds opportunities to invest, in other words, monetary supply is greater than effective investment demand. The following are some of the reasons that explain this trend:

- The rate of profits in the real economy in the past two decades has been continuously lower than the interest rate and returns on securities’ investment. This trend has been unprecedented in 200 years of economic history, at least in peacetime. Consequently, profit accumulated in the real economy has drifted into the financial sector.
- Economic policies, driven by the neoclassical liberal theory, accelerated the devaluation of the real economy compared with the financial sector. By the 1980s, monetarist economic policies had become predominant in developed market economies. These policies declared inflation public enemy number one, and condemned financing of the budget deficit through financial market instruments. Slower inflation brought interest rates down and lifted stock prices.
- A rise in stock prices has attracted investors. Investing in shares proved to be more profitable than keeping savings in banks, holding government securities, or putting money in businesses. Both the number of investors and the amount invested on the stock exchange rose dramatically. The public in the industrial countries holds about two to three times as much savings in stocks as 10 years ago.
- Compliance with the Maastricht criteria and the Brussels decision to introduce the euro propelled governments in the European Union to reduce budget deficits. As a result, the emission of government securities was cut back, and the money, spent earlier on government securities, was now flowing onto the stock exchange.
- Public companies have repurchased an annual $200 billion of their own stocks. During an across-the-board market upsurge, this proved to be a good investment. Also, stock-buying options have been playing an increasingly important role in compensating the top managers, so they became even more motivated to maintain or increase the value of their own stocks.

The neoclassical economic theory considers only price increases in the goods market as inflation. A steep increase if share prices is not considered a harmful trend that needs countermeasures. And while stock prices often jumped by 20-40 percent annually in the past two decades, especially in recent years, the annual inflation in the goods market has remained at 2-3 percent. Money, though a particular commodity with a particular market, is still a commodity and its price still moves according to the market laws where supply and demand de-
termine prices. The two-digit inflation that has become a permanent phenomenon in the capital market, meant that stock prices have risen disproportionately, compared with both the price level of other commodities and the rise in profits. In the capital market, demand has been significantly larger than supply. From another angle: the supply of investment money considerably exceeded the supply of desired, acceptable investment opportunities (that is, investment demand).

The present stock market crisis is different from the one during the Great Depression between 1929 and 1933. Back then, the snowball was set in motion by the bankruptcy of Austria's Creditanstalt bank. It gained impetus afterward through the crash of the New York Stock Exchange, and then spread almost instantly to the international financial markets. The situation of the 1990s is no less threatening and the risk of a financial crisis is no less serious than it was at the end of the 1920s. There are, however, several mitigating factors:

- The international financial system has learned its lesson from the great depression
- The industrial economies are stable
- The global information economy is more layered along center and periphery lines than was the world economy in the 1930s, thus the crisis can be isolated in time.

The lurking financial crisis could be checked by strengthening the real economy. If profit expectations improve, money will flow from the stock market to manufacturing and services. This process can be accelerated through the encouragement and extension of research and development, innovation, training and other intellectual-cultural investments. In the "Visegrad economies," if intellectual capital can be made available to businesses that are listed on the stock exchange, real foundations for higher stock market prices can be created. This economic policy also increases domestic purchasing power through higher income and consumption by expanding the workforce which creates a higher added value.

Virtual Knowledge about Russia's Virtual Economy
by Stanislav Menshikov

I wonder whether Ickes and Gaddy ("Underneath the Formal Economy—Why Are Russian Enterprises not Restructuring? Transition, August 1998, p.1) have ever seen a Russian input-output table? The latest one available for 1995 shows that there were only four industries in Russia that were net subsidy receivers: coal, agriculture, communal services, and science. All other industries were value creators under any valid definition of the term, whether it is gross value added to material (intermediate) inputs or in the more narrow sense of covering labor costs, too.

This major statistical evidence is supported by national accounts statistics, also available for 1996 when profits in Russia deteriorated sharply. Even then, practically all branches of the economy remained value creators, not value destroyers. To Russian economists with a first-hand knowledge of facts and figures, claims about value destruction as a general rule in Russia seem at best a wild fantasy.

The Russian situation is very similar to that of the U.S. economy in the Great Depression of the 1930s. A look at Historical Statistics (a classic statistical reference source for that period and earlier times) shows that gross value added fell drastically in all industries, while quite a few showed a net loss (rather than profit) industrywide. Would Ickes and Gaddy claim that the U.S. economy was a major value destroyer at the time?

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The authors are Hungarian economists; Mr. Matolcsy is director of the Economic Growth Institute, E-mail: Property@Hungary.Net
holders and the stock market, not the abstract opportunity cost concept.

Of course, all business executives, whether in the west or in Russia, instinctively follow the rule of minimizing potential losses, which lies at the heart of the opportunity cost concept. But in its pure form the rule of minimizing potential losses is good for the classroom, not for the corporation boardroom or for the floor of the New York Stock Exchange. As for the stock market, which is an important indicator for guiding corporate decisions, its permanent zigzags in market values and company capitalization, with very little direct connection to real value, make it no less "virtual" than Russia's predominantly barter economy.

That is not to say that barter is admirable. Of course, it is not. But unless the banking system in Russia is thoroughly reformed, barter and interenterprise arrears are unavoidable. The previous governments (together with the IMF) have practically ignored the issue. The Primakov government shows signs of recognizing the importance of these issues. I have to conclude that, with all due respect, Ickes's and Gaddy's concepts on value destruction have little relation to Russian realities.

The author is section head at the Central Institute of Mathematical Economics (CEMI), Russia, and a research fellow resident in Rotterdam, Netherlands. 
Email: menschikov@globalxs.nl

Response to Menshikov—The Causes of Crisis
by Barry W. Ickes

The statistics that have been offered to "prove" that [Russian] enterprises are not value destroyers are uninformative unless we know the actual prices at which transactions are made. When transactions are reported in ruble values but paid for with instruments that trade at a discount, the resulting figures cannot demonstrate what people are claiming they do. I have argued that you cannot simply add the ruble values of transactions that take place with instruments that trade at different discounts to each other. Menshikov apparently disagrees.

Menshikov goes even further, however. He argues that it is logically without foundation to question figures when we are uncertain as to their actual amounts. It is as if we must decide if a heavy load can safely make it across a bridge. When informed that the weight of the cargo may in fact be twice what is recorded, and that the load-bearing capacity of the bridge may be half of what is reported, Menshikov would argue that the cargo should pass anyway: if we are not certain of the degree to which the figures are inflated we cannot question the safety of the trip. I don't think Menshikov's logic makes for a good safety engineer; I certainly will avoid his bridges. I don't see why this logic is any more satisfactory for studying economics.

Menshikov's argument seems to be that measuring value added at world prices is of no relevance. He is correct to state that no matter how inefficient is manufacturing, Russia must have a comparative advantage in some activity. But in that case Russia' comparative advantage may not be in manufacturing. If Russian manufacturing uses energy less efficiently than foreigners do, then the theory of comparative advantage says it should export the energy and import the manufacturing goods. At world prices it may be that manufacturing is not competitive, and that it can only survive if value is redistributed from elsewhere. This can take the form of protective tariffs or of the virtual economy.

There are too many confusions in Menshikov's comments on opportunity cost to discuss here. The key issue between Menshikov and myself appears to be over the causes of the crisis in Russia. Menshikov sees the output decline due to lack of demand. I see it as the result of too many inefficient producers that cannot compete in an open economy. Without protection, Russia exports commodities and imports consumption goods. Menshikov sees an increase in nominal spending leading to an increase in output as consumers buy the output of Russian industry. I see an increase in nominal spending leading to increased purchases of imports and a resurgence of inflation. Menshikov sees an increase in credits to these industries leading to a revival of production. I see an increase in credit to these industries leading to more unusable production. The Russian government may be about to conduct the experiment. We will learn from the outcome of that.

The author is professor in the Department of Economics, Pennsylvania State University, University Park, PA. 16802 USA, tel. 814-863-2652, fax 814-863-4775, E-mail: bwickes@psu.edu Internet: http://econ.la.psu.edu/bwickes/index.htm, and, The New Economic School, Nakhimovsky prosp. 47 Moscow 117418, Russia, tel.7-095-129-3722/3844, fax 7-095-129-3722, E-mail: obudjko@nes.cemi.rssi.ru

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Shall We Forget the Latin American Precedents?
by Katharina Mueller

Michal Rutkowski provides a good overall perspective on the recent pension reform trends in transition economies. However, I disagree with his leitmotif that the "new generation" of pension reforms in this region is different from those in the existing Latin American blueprints. When predicting that "transition economies are increasingly likely to end up with mixed systems," that combine a public, pay-as-you-go and a private, fully funded component on a mandatory basis, Mr. Rutkowski is right. However, this type of old age security reform was pioneered by Argentina (1994) and Uruguay (1995). Consequently, Carmelo Mesa-Lago, a well-known scholar of Latin American pension reforms, had already coined the label "mixed reform" for this paradigmatic choice (as opposed to the "substitutive" Chilean case).

The parallels between the basic set up of the "Argentine model" and the current Hungarian and Polish reform paths are striking, and Dimitri Vittas, one of Mr. Rutkowski's colleagues at the Bank, recently has stressed the relevance of the Argentine model for Eastern Europe. Therefore, I am very surprised that the former leader of the Polish pension reform team is unwilling to acknowledge the conspicuous borrowing from the Argentine precedent (even if, admittedly, the Latvian example was also influential in the Polish context). Is this because it has turned out that the (still radical) mixed pension reforms sell better in the region without explicit reference to Latin American blueprints, given that Central Europeans are very sensitive to having any kind of Latin Americanization proposed to them?

The author is professor at Frankfurt Institute for Transformation Studies at European University, Viadrina, Frankfurt/Oder, Germany, Email: kmueller@euv-frankfurt-o.de

Milestones of Transition

Central and Eastern Europe

Crisis reduces private capital flows. The world's financial crisis is expected to reduce private capital flows into Central and Eastern Europe by 35 percent this year. The global organization of commercial financial institutions, the Institute of International Finance (IIF), says it expects private capital, which had topped $67.5 billion flowing into the region in 1997, to drop to just over $44 billion this year. It projects that the flows will improve only by $200 million, to $44.2 billion in 1999. In recent years private capital has become the major source of financing for emerging market economies around the world. In 1997 the private flows into Central and Eastern Europe were eight times the official flows from other governments and international institutions like the IMF and the World Bank. The IIF is urging investors to differentiate between those countries that are in trouble and those—primarily in Central Europe—that have been doing a good job. The Washington-based IIF has a membership of 300 commercial banks, investment funds, insurance companies, and pension funds worldwide. (From RFE/RL correspondent, Robert Lyle)

EU advisers to boost East's administrative capacity. The European Union is about to launch a new effort to help the 10 Central and Eastern European applicant countries make the administrative reforms essential to their respective memberships in the EU. Within the next few months the EU Commission will send experts to each of the 10 countries to advise the host governments on how to make their administrative practices conform to EU legislation. Under the initial $80 million-phase of the program, almost 100 projects will start in the first few months of next year. Romania tops the list with 19 projects, followed by Hungary with 16, Slovenia with 14, and Slovakia with 13. The other countries are Poland will have six projects, the Czech Republic seven, Bulgaria six, Estonia four, Lithuania eight, and Latvia five. Called "twinning," the program aims to pair bureaucrats and technical experts from EU member states with counterpart officials in the Eastern European host countries. The initial series of twinning involves four key areas: agriculture, environment, finance, and justice and home affairs. (From RFE/RL correspondent, Breffni O'Rourke)

Shakeout in Estonia's financial markets continues. In early October the Estonian Central bank honored the troubled ERA bank's request to have its license suspended for two weeks. The ERA bank wanted to close its doors because it feared it could no longer guarantee the deposits of customers. ERA bank deposits represent only about 2 percent of all Estonian bank deposits. The Estonian securities administration halted the trading of eight investment funds. In all

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TRANSITION, October 1998
cases, the net value of the funds had fallen below the minimum requirement of 5 million koons. Most of the funds had investments in Russia's financial markets. Decline of the Estonian stock exchange has been attributed mainly to upheavals in the banking sector and illiquid markets. During the month of October uncertainty reigned in all three Baltic financial markets.

Hungary GDP up 4.8 percent in first half. Hungary's GDP was 4.8 percent higher in the first half of 1998 than in the same period last year, the Central Statistics Office reports. Exports of goods and services rose by 22 percent, imports by 25 percent and 11 percent more was spent on investment projects in the first half than in the same period of last year. The largest item in domestic consumption, personal consumption, rose by 2.9 percent in the first half, and by 4.3 percent in the second quarter. Consumer prices rose by 15.3 percent in the first nine months. Real wages rose by 3.3 percent between January and August. The current account deficit totaled $1 billion in the first eight months, $285 million more than in the same period last year. The general government deficit, not including local governments, was 350 billion forints ($1.7 billion), in the first nine months, 66 billion forints more than one year earlier.

Slovakia
National chapter of Transparency International. The Center for Economic Development, Bratislava, as an acknowledgement of its devotion in combating corruption and supporting increased transparency, was entrusted to organize and be responsible for the local chapter of Transparency International. As of September 21, 1998, the Slovakia chapter has been launched under the guidance of the preparatory committee: Eugen Juryzca, Emilia Sicakova, and Rastislav Kovacik.

Romania

Economic performance worsens. Romania's GDP dropped by 5.2 percent in the first six months of 1998, compared with the same period last year, the National Statistics Board said on 30 September. The balance of trade deficit for the same period has grown to $1.66 billion, compared with $1.36 billion in the first half of 1997. Exports dropped by 8.9 percent and imports by 12.8 percent.

CIS

Azerbaijan

Caspian pipeline decision imminent. The Azerbaijan International Operating Company (AIOC) will make its recommendation in November on the optimal route for the so-called Main Export Pipeline for Azerbaijan's Caspian oil, President Heidar Aliyev said in October. Aliyev reaffirmed his determination that the route, leading from Baku to the Mediterranean port of Ceyhan in Turkey, should be chosen. (This pipeline avoids both Iran and the northern route through Russia and Georgia.) Aliyev's son Ilham, who is deputy president of the Azerbaijan State Oil Company SOCAR, also denied that Baku is contemplating an alternative oil route. American oil company executives and top U.S. government officials admitted at a special meeting that the 1,080-mile Baku-Ceyhan pipeline is not currently commercially viable. They stressed, however, that it would be built if Caspian oil exports grow sufficiently. Persistently low oil prices over the past year, as well as a series of disappointing exploration wells, have led to a downgrade of near-term estimates of export volumes from the Caspian.

Kazakhstan

Liberalization measures. In his annual address to parliament on September 30, President Nursultan Nazarbayev outlined broad measures to expedite democratization. He proposed curtailing the powers of the president and increasing those of parliament, making the government more accountable to the parliament, enhancing the independence of the judiciary by appointing a separate head of the Supreme Court (that post is currently held by the country's president), and privatizing some state-owned media.

Ukraine

Government restricts foreign currency purchases. In a bid to stave off the depletion of its reserves, the Ukrainian National Bank (NBU) has sharply tightened procedures for purchasing foreign currency as of October 1. The new rules stipulate that foreign currency can be purchased by authorized banks only if their customers produce the required documentation, which include foreign-trade contracts and tax and customs clearance. Banks are obliged to provide the State Tax Administration with information about customers' desires to buy foreign currency, including passport details of customers' employers and accountants. Permits for purchasing foreign currency are to be issued by NBU regional departments.

Asia

Vietnam

Government seeks boost in rural economy. Vietnamese Prime Minister Phan Van Khai told the country's national assembly that his government would attempt to tackle worsening economic problems with a new emphasis on rural and agricultural development. Khai said that Vietnam would try to create more than a million new jobs next year and would aim for GDP growth of between 5 and 6 percent.
Conference Diary

Meeting of the International ECPD Permanent Study Group on Transition and Privatization
December 4-5, 1998, Belgrade, FR of Yugoslavia

Organizer: The European Center for Peace and Development (ECPD) of the University for Peace, established by the United Nations.

Topic: Recent lessons from Transition and Privatization—Problems of Institutions and Corporate Governance. The gathering will bring together a mix of academic economists, corporate representatives, and government advisers to update information and review and generate some ideas on postprivatization ownership structures and their impacts on enterprise performance, institutional changes, corporate governance and restructuring of large loss-making enterprises, as well as the role of the financial sector in promoting enterprise reform.

Information: Gordana Hofmann, European Center for Peace and Development (ECPD) of the University for Peace, established by the United Nations, Belgrade, Terazije 41, Yugoslavia, tel. 381-11-3246-041, 3246-042, 3246-043, 3246-044, 3246-045, fax 381-11-3240-673, 3234-082, E-mail: ecpd@afrodita.rcub.bg.ac.yu

Investment Opportunities in Kazakhstan: Exploit New Opportunities to Realize Investment Potential
December 8-9, 1998, London, United Kingdom


Topics: Economic and Business Outlook: The Continuing Role of the EBRD in Kazakhstan; Investment and Export Prospects in the Oil and Gas Industry.

Languages: English and Russian.

International Conference: Recent Developments and Problems in the Transition Economies
March 25-27, 1999, Skopje, Macedonia

Organizer: Faculty of Economics, Sts. Cyril and Methodius University, Information: Mrs. Valentina Ganzovska, Faculty of Economics, Blvd. Krste Misirkov bb, Skopje 91000, Macedonia, tel. 38991 223-245, fax 38991 118-701, E-mail: valentina@eccf.ukim.edu.mk

Passauer Workshop—Internationale Wirtschaftsbeziehungen (First Passau Workshop—International Economic Relations)
April 15-17, 1999, Passau, Germany

Organizer: University of Passau, Department of Economics, Institute for Finance and Foreign Relations.

Applications including a 2-3 page summary of the planned lecture in German, name, title, key words, JEL classification and address and institutional affiliation of the lecturer accepted until December 1, 1998.

Information: Carsten Eckel, Lehrstuhl fuer VWL mit Schwerpunkt Geld und Aussenwirtschaft, Universitaet Passau, 94030 Passau, Germany, tel. 49-851-509-2534, fax 49-851-509-2532, E-mail: eckel@uni-passau.de, Internet: http://www.wiwi.uni-passau.de/lehrstuehle/ruebel/pwiw/home.htm

Third International Conference on Enterprises in Transition
May 27-29, 1999, Split, Croatia

Organizer: Faculty of Economics, Split, Croatia.

Language: English

Call for papers: Deadline's December 31, 1998.

Information: Enterprise in Transition, Faculty of Economics, Radonanova 13, HR 21000 Split, Croatia, E-mail: eitconf@efst.hr, Internet: http://www.efst.hr/eitconf/

Summer Symposium for Graduate Students in International Affairs
June 10-15, 1999, Annapolis, MD and Washington, D.C., United States


Topics: Citizens, Civil Society, and Conflict; The Nuclear Cities’ Initiative—Ethnic Conflict in the 21st Century, the UN and Civil Societies; Latin America: Politics for the 21st Century.

Open to individuals enrolled in a master's or doctoral program. Costs are covered by WIIS.

Information: Women in International Security/CISSM, University of Maryland, College Park, MD 20742, United States, tel. 1-301-405-4020, fax 1-301-403-8107, E-mail: dsmith@puafmail.umd.edu, http://vww.puaf.umd.edu/WIIS

31st National Convention of the American Association for the Advancement of Slavic Studies (AAASS)
November 18-21, 1999, St. Louis, Missouri, United States

Organizer: AAASS

Information: http://fax.harvard.edu/

32nd National Convention of the American Association for the Advancement of Slavic Studies
November 9-12, 2000, Denver, Colorado, United States

Organizer: AAASS

Information: http://fax.harvard.edu/
Wolfensohn Outlines World Bank's
Development Strategy

World Bank Group President James D. Wolfensohn, in his speech to the 1998 Annual Meetings of the World Bank and the International Monetary Fund, called for a reform agenda that addresses issues of governance and social justice as well as far-reaching corporate and financial sector reforms. He confirmed that, while private sector flows fall, the Bank would continue to play its part by maintaining last year's higher level of lending in support of this agenda. He also pledged more spending for immediate social safety nets. The World Bank was moving toward a new approach, one that would move beyond projects and, in partnership with governments and civil society—including the private sector, rigorously pursue the social and structural priorities.

The new framework of the Bank would embrace five guiding principles:

- Supporting good governance—transparency, the free flow of information, a commitment to fight corruption, and well-trained, properly remunerated civil servants
- Supporting a legal system that guards against capricious actions—a modern, and transparent financial system that is adequately supervised, with internationally recognized accountancy and auditing standards
- Supporting policies that foster inclusion—education for all, especially women and girls, health care, social protection, and early childhood development
- Supporting public services and infrastructure necessary for communications and transport, as well as policies for creating liveable cities and addressing problems of growing urban areas
- Supporting environmental and human sustainability that would including water, energy, food security, and cultural heritage to ensure that development is firmly based and historically grounded.

The Bank Helps Preserve Cultural Heritage

In the transition economies of Europe and Central Asia, the Bank is working on 11 cultural heritage support projects. The St. Petersburg project ($21 million) and the Georgia project ($5 million) are already being implemented. Nine other programs—in Albania, Azerbaijan, Bosnia, Bulgaria, Croatia, Macedonia, Romania, Turkey and Uzbekistan—are being prepared. As Maritta Koch-Weser, director of the Environmentally and Socially Sustainable Development Unit, Latin America and the Caribbean region, pointed out, the Bank’s initiative involves assistance for a variety of conservation and support activities, working in close collaboration with nongovernmental organizations and other specialized agencies such as UNESCO, the Council of Europe, and the World Monuments Fund.

U.S. Funding Conditions to IMF

The International Monetary Fund and its biggest members, the Group of Seven industrial nations, are likely to accept the strings that Congress is attaching to the $18 billion U.S. contribution, according to news reports. U.S. support to the IMF would be contingent on the chairman of the Federal Reserve and the secretary of the Treasury certifying that major IMF shareholders have agreed to:

- Require borrowing countries to set schedules for liberalizing trade, eliminating government-directed lending and approving bankruptcy laws fair to all creditors
- Require the IMF to publish summaries of board meetings, letters of intent, and policy papers with exceptions
- Require that loans to countries threatened by sudden loss of market confidence be paid back within one to two-and-a-half years and cost 3 percentage points above market rates.

Public Information Center in Bosnia

On October 9 the World Bank Permanent Mission to Bosnia opened a Public Information Center, which will offer information on Bank operations in Bosnia and worldwide. The center is offering documentation on projects, sector studies, and economic reports on Bosnia, as well as a small library allocated to publications, dealing with countries in development and transition. (Internet address: http://www.worldbank.org.ba)

Ukraine and IMF at odds over the restructuring of domestic debt

The IMF suggested that the Ukrainian government would violate the agreed-on three-year economic reform program if it converted funds paid to foreign investors in hryvnias into dollars. The move, the IMF noted, would drain Ukraine’s foreign currency reserves below the level agreed-on with the IMF. According to the IMF, holders of such paper would have to agree to rolling over their earnings or accepting payment in hryvnias. However, at the end of 1997, the Ukrainian Central bank and government issued a special resolution in connection with the bonds whereby investors would be allowed to convert their earnings to dollars.

World Bank FY98: Declining Net Income

The net income of the International Bank for Reconstruction and Development (IBRD), part of the World Bank, fell to $1.24 billion in fiscal 1998 from $1.29 billion in the previous fiscal year, according to the Bank’s annual report released end-September. Modest interest rates
and higher loan-loss provisioning were mainly responsible for the decline last fiscal year, which ended June 30, said Mark Malloch-Brown, vice president for external affairs at the Bank. (As a result, after the last fiscal year ended, the Bank’s Board approved a higher fee structure aimed at improving the Bank’s net income. The Bank increased the spread that is charged to borrowers above funding costs to 75 basis points from 50 basis points, and it added a front-end fee of 100 basis points.)

Stepped-up provisioning due to a significant amount of new loans to countries in crisis also affected net income. In fiscal 1998 provisioning for loan losses amounted to $251 million, compared to only $63 million in the previous fiscal year.

Vietnam Accelerates Assistance Implementation

The World Bank’s Vietnam Country Team met with officials from Vietnam’s Ministry of Planning and Investment (MPI) at the end of October to discuss the improving quality of Vietnam’s investment portfolio and the Bank’s new partnership program launched earlier this year. A joint project of the World Bank and Japanese trust funds to address implementation obstacles of official development assistance (ODA) in Vietnam, is near completion. (ODA to Vietnam now totals more than $10.8 billion in commitments and runs at more than $2.4 billion annually for the past few years.) The project provided training programs for government staff and improved the policy environment for investments. (Annual ODA disbursements have climbed steadily to about $1 billion in 1997. The World Bank has disbursed more than $700 million of its $2.1 billion in commitments to date.) Under discussion were the Bank’s proposed Portfolio Improvement Plan for FY98, which will focus on continued assistance to Vietnam’s government with special regard to the growing number of locally targeted rural and social sector programs.

New Books and Working Papers

The Macroeconomics and Growth Group regrets that it is unable to provide the publications listed.

World Bank Publications

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Working Papers

To order: Cynthia Bernardo, Room MC2-501, tel. 202-473-1148, fax 202-522-1154, Internet: cbernardo@worldbank.org. The author may be contacted at dvandewalle@worldbank.org.

The very principles on which Vietnam’s highly decentralized, community-based assistance and safety net system is built are threatened by the country’s increasing household mobility, without which the market system cannot function. Developing a reliable, effective system of redistributive transfers and safety nets to replace faltering local institutions will be important if Vietnam is to make a successful transition to a market economy.

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Argentina, a leader among developing countries in restructuring its banking sector, privatized roughly half of its public provincial banks. The provincial banks that remained in the public sector did not demonstrate the same performance gains as privatized provincial banks. Authors estimate fiscal savings associated with privatizing the banks rather than keeping them public and later recapitalizing them. The privatization process included setting up residual entities for the public provincial banks’ assets and liabilities that private buyers found unattractive, and creating a special fund (Fondo Fiduciario) to convert the short-term liabilities of these residual entities into long-term obligations. The Fondo, created through cooperation between Argentina’s government and the World Bank, was key in making bank privatization politically feasible.

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To order: Patricia Sader, room MC3-632, telephone 202-473-3902, fax 202-522-1153, Internet: psader@worldbank.org. The authors may be contacted at jjalan@worldbank.org or mravallion@worldbank.org


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To order: Sheila Fallon, Room MC3-638, tel. 202-473-8009, fax 202-522-1153, Internet address sfallon@worldbank.org. The authors may be contacted at dfilmer@worldbank.org or lpritchett@worldbank.org


The economic transition from a command to a market economy is a complex, messy process, during which the incentives of economic agents may be significantly different from those familiar to Western economies. Thus attempts to transplant Western institutional and regulatory norms of good practice into transition economies may produce disappointing, even counterproductive, results.

The safety of an individual bank depends on the bank's own internal information and information processing capabilities; on the sophistication of the banking products it offers; as well as on the external operating environment that the bank faces. Bank "safety" is an elusive concept in transition economies. A transitional banking system may be quite "safe" even though regulatory reform may have progressed only minimally. The analysis helps to account for several paradoxes observed in transition banking systems, including the relatively long-term survival of banks that, by any objective standard, are insolvent.


Since the late 1980s the energy sector in many countries in Europe and Central Asia has been affected by excess production capacity, lower-quality supplies, decreasing demand, and inefficient consumption. This report outlines the four main reform objectives of the World Bank: assisting governments to protect the public interest, supporting economic transition, facilitating private investments, and promoting regional initiatives to increase energy trade.


Other World Bank Publications


Public finance reform is simultaneously a process of fiscal adjustment and structural reforms in the public sector. Under socialist rule the concept of public finance was nebulous, since there was no clear delineation between private and public sectors. Making the transition from a socialist economy requires profound institutional changes, primarily to create a government sector that is adapted to the market economy.

The macro situation was not favorable: the transition-generated recession, an increasing fiscal disequilibrium, complicated the life of the decisionmakers. The stabilization program announced in March 1995 was accompanied by a wide ranging structural reform program. Cuts in government expenditure (from 60 percent of GDP in 1994 to 50 percent by 1996) reduced the fiscal deficit, and in 1997 Hungary resumed economic growth.

This volume provides a comprehensive description of Hungary's experience with public finance reform, including a history of the reform process; an empirical analysis of trends in public spending and revenues; evidence of Hungary's ability to move toward accession to the European Union (EU); a description of policy reforms in the public welfare system; an analysis of the reforms in key social areas (such as pension, health care, and education), in public management (treasury, local government, and wage and employment), as well as in the tax system.


A compilation of reports on 193 research projects of the World Bank that have been initiated, are under way, or completed in fiscal year 1998 (which started on July 1, 1997). The abstracts describing the analytical methods used, the findings to date, and their policy implications are grouped under nine main headings: transition economies, poverty and social welfare, labor markets and education, environmentally sustainable development, infrastructure and urban development, macroeconomics, international economics, domestic finance and capital markets, and private sector development and public sector management.


This comprehensive World Bank study takes a look at what happened to the East Asia miracle—to the region's trade and competitiveness, its financial sector, the corporate sector's financial performance and governance, the depth of the social crisis, and what should be done to help East Asia on the road to recovery.

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Author analyzes and reconsiders one of the great economic dramas of Western history, the march to capitalism in Russia, Hungary, Poland and the Czech Republic. The period is from 1989, after the fall of the Berlin Wall, when the liberated countries rushed headlong into democracy and capitalism. Special emphasis is on the role, often misunderstood, played by the International Monetary Fund and the World Bank. They financed and guided the transition, while issuing free-market strictures in the process. Russia, in its agony, offers a laboratory for the conflicting claims of free-market theory against a more pragmatic, experimental approach. China’s hybrid-capitalism is also analyzed and compared.

The author puts forth a new forecasting and planning methodology for transforming a socialist or closed and/or mixed economy to a free market economy. The methodology makes use of existing structures and capital stock during transition, as opposed to a complete destruction brought about under a “big bang” approach. Author analyzes weaknesses of other forecasting methods that have been developed for transformation.

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The volume describes the radical restructuring of the countryside in Albania, Bulgaria, the Czech Republic, Eastern Germany, Hungary, Poland, Romania, Slovakia, and Slovenia. It examines the economic and political history of Central and Eastern Europe, in the context of the transition process. Restoration of property ownership meant partial restitution of former owners, and survival of a large number of cooperatives on voluntary basis, and on a reduced scale. State farms were either dissolve or transformed to joint-stock companies. In perspective, the challenge is to create competitive commercial farms. To retain viable communities, creating new employment opportunities, in rural areas the service sector should be further developed.


The author criticizing the shock therapy, and argues that transition to a market economy cannot simply be achieved through filling the supposed vacuum left by the collapse of central planning. The present mix of old and new institutional structures contribute to economic fragmentation and divergence.

Other Edward Elgar Publications


Authors, in their search for ingredients of a successful transition to a market economy, are focusing on four major issues of the monetary and financial sectors that emerged in Central Europe:

- Removal of state intervention and its effect on liquidity, and the availability of credits.
- Failure of credit markets (credit crunch) and the implications for corpo-
rate finance.

Role of property rights and the importance of bankruptcy in a well-functioning market economy.

Effects of separating the central bank from its commercial lending functions, and the consequences for implementing monetary policy.


Other Publications


To order: http://www.rutgers.edu/Accounting/raw/ima/publications/newbooks.htm

Russian accounting had a “glorious” past until 1917. The system that developed after 1920, served well the Soviet authorities in their policy of centralized planning, and administrative control. The book analyzes new development in Russian accounting and auditing and also describes major shortcomings of the tax system-and collection.


The Free Market Institute of Lithuania undertook this survey form November 1997 to March 1998, interviewing about 50 entrepreneurs (from banks, industrial and commercial businesses), to evaluate present economic situation and provide forecast for the year ahead. Some results of the survey: GDP growth in 1998 will reach 5 percent; the shadow economy will contract slightly, but still will be above 20 percent of GDP, the average household income will also rise slightly, reaching 2,600 litas in cities, and 1,150 litas in rural areas.

To order: Free Market Institute of Lithuania, 56 Birutės St. Vilnius 2004, tel.: 822-722-584, fax: 822-721-279, E-mail: tfmi@lri.omnitel.lt


Privatization aid to many Central and Eastern European enterprises proved to be largely ineffective when its implementation ignored local authorities and organizations. As assistance moved east, the same lessons had to be relearned in each new recipient country. Local officials in Ukraine voiced complaints almost identical to those of Central European officials, expressed several years earlier: that donors sent fly-in-fly-out advisers who were burdensome, stayed in expensive hotels, and knew little about the host country (in Poland they were dubbed the “Mariott Brigades”). In Russia, on the other hand, donors preferred to work through local elites who “could get things done” through their personal connections. Thus donors have lent resources and legitimacy to communist-style organizations, undermining attempts to build independent institutions and fomenting resentment against the elite cliques that benefited.


The report is published through the MONEE project (Monitoring Public Policy and Social Conditions in Central and Eastern Europe, the CIS, and the Baltics). The focus of this year’s report is education, including enrollment and other measures of access, learning achievement, schooling costs, and the decentralization of educational systems. The free database of socioeconomic indicators for 27 CEE/CIS countries (TransMONEE 3.0) allows the retrieval and manipulation of economic and social indicators updated through 1996, from different Web sites.

For more information, access the UNICEF ICDC Web site at: http://www.unicef-icdc.it/information/databases/index.htm, or the Centre for Europe’s Children at http://eurochild.gla.ac.uk, or contact: Economic and Social Policy Programme, UNICEF ICDC Piazza SS. Annunziata, 12 50122 Florence, Italy, tel. 39-055-234-5258, fax 39-055-244-817 E-mail: CIUSCO@UNICEF-ICDC.IT


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Information about a fast-developing EU database—already 1500 bibliographical units, more than 300 experts and nearly 200 institutions are searchable in "Countdown". It will include, in addition to the 15 EU countries, data about the future members. The main partner in collecting literature on eastern enlargement published in the EU countries is the German Institute for Economic Research (DIW, Berlin). It is expected that the Institute for Economics and Finance, University of Parma, Italy, and the Department of International and European Economic Studies, Athens University of Economics and Business, Greece, will also join the project under the auspices of the Commission's INTERREG II/C initiative. Information: "Countdown" project manager: Sandor Richter, Vienna Institute for International Economic Studies (WIW) http://www.wiiw.ac.at/, Oppolzergasse 6, 1010 Wien, Austria, tel. 431-533-6810-25 fax: 431-533-6610-50, E-mail: richter@wir.ac.at

Energy Frontiers, Newsletter dealing with energy and power opportunities in Eastern Europe and the CIS countries.


To order: 13555 Bishop's Court, Brookfield, WI 53005-6286, United States, tel. 414-784-9177, fax 414-784-8133, E-mail: ldiefenbach@dieselpub.com, Web site: www.dieselpub.com

Horizonti, the magazine for the third sector in Georgia.

To order: Horizonti, 33 Gogebashivili St., Tbilisi, Georgia, tel. 995-32-29-29-55, fax 995-32-98-75-04, E-mail: presscenter@horizonti.org, Internet: http://www.horizonti.org

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