Anti-Depression Cure for Ailing Postcommunist Economies
Interview with Janos Kornai

Against all official predictions, economists await the first signs of economic revival in Hungary. By the end of 1992, gross domestic product—according to reports by (Hungarian) Economic Research, Ltd.—had dropped by almost 20 percent, and industrial production by 32 percent, compared with 1989 production levels. The number of registered unemployed is approaching the 700,000 benchmark—a 13 percent unemployment rate in a country that hadn't had statistically meaningful unemployment since the communist takeover in 1948. In Hungary, the "reform model-economy" has resulted in a decline in output that has been steeper than industry's contraction during the 1929-32 Great Depression. The dimensions of the economic free-fall are alarming even for Poland, Hungary, and the Czech Republic this year. Oxford Analytica is also optimistic, but more cautiously so. (page 5 and 6)

Central and Eastern Europe: Economic Predictions 1993
PlanEcon Director predicts a recovery for Poland, Hungary, and the Czech Republic this year, and a deferred upturn for most other postcommunist economies in that region. Oxford Analytica is also optimistic, but more cautiously so. (page 5 and 6)

Foreign Direct Investment in Central and Eastern Europe
What to expect? (page 5)

Quotation of the Month
James Brown of Radio Free Europe on the importance of hope and on the danger of uncontrolled forces in Eastern Europe. (page 8)

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Structural Changes in Eastern Germany
Are there any recipes for preventing a German "mezzogiorno"? The author isn't that sure. (page 10)

Letters to the Editor—The Tolar and the Kroon
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sored conference in Washington in June 1992 (Transition, July-August 1992) concluded that measured output declined sharply when comprehensive reforms were put in place. Other current research efforts also trace the causes of the recession in the postcommunist world. How much do you rely on this research and are there findings that could be used to improve governments’ anti-recession policies?

A. Much current research focuses on the economic decline and stagnation of the postcommunist societies. Some studies explain the downfall with a single cause, such as the collapse of the Soviet market and the breakdown of the Comecon arrangement, or the extreme contraction of aggregate demand, provoked by excessively restrictive monetary and fiscal policies. I cannot accept these explanations.

I think what happened was the combined effect of several, strongly related factors. Of course I’m not the only one searching for a multi-causal explanation; I have found several papers—including World Bank research, such as the Simon Commander and Fabrizio Coricelli study—that take similar approaches. [Editor’s note: see also “Persistent Economic Decline in Central and Eastern Europe,” published in 1970, you suggested that the shift from a sellers’ to a buyers’ market could be done without a decline in output. Have you revised your opinion on this?]

Q. In your earlier work “Anti-Equilibrium,” published in 1970, you suggested that the shift from a sellers’ to a buyers’ market could be done without a decline in output. Have you revised your opinion on this?

A. At that time I thought one could shift from a sellers’ to a buyers’ market and eliminate the shortage economy with much less sacrifice. I thought that while supply grew at a steady rate, demand could be decelerated, ensuring a market equilibrium with potential slacks in the economy. I have to admit I was too optimistic. Aggregate demand is declining, and it is dragging down aggregate supply even more steeply. Although restricted demand results partly from a deliberate government policy to eliminate shortages through open inflation, it is also partly happening against the will of policymakers.

Q. Consumers are feeling the squeeze—consumption fell steeply in recent years. But what happened to investment, the other basic component of aggregate demand. Where are the investors hiding?

A. A drastic fall in investment is another cause of the transformation recession. In Hungary, investment on comparable prices dropped 25 percent between 1981 and 1992; the ratio of fixed capital formation as a percentage of GDP fell from 28.8 percent in 1980 to 18.6 percent in 1991. Under socialism enterprises didn’t require...
additional stimulus for investment; public money fed their insatiable hunger for investment and expansion. This is over. Political accountability—and how tax money is spent—is now subject to public scrutiny. Spending restrictions and new oversight measures have been imposed. The government has had to curtail public investment, including infrastructure and social expenditures, as budget revenues have diminished and the budget deficit has grown.

State enterprises have also been afraid to invest: many are in financial trouble; those left in the public sector fear that budget constraints will harden and that their cash flow will dry up; state-owned enterprises expecting privatization are practically paralyzed; and state managers are not prepared to commit themselves to any enterprise development before property questions are settled. And private firms, even if ready to grow, also face various obstacles: the capital market is still weak, the tax burden is heavy, and the banking sector is extremely cautious and charging high interest rates.

Q. That is one more reason to go ahead with the adjustment process, restructure the economy, and generate the proper supply response...

A. Output structures developed under the communist regime have to be changed. Forced growth shaped a certain output composition, with strong emphasis on heavy industry and military production, neglecting production of consumer goods, provision of services, and development of infrastructure. Buyers were forced to accept the distorted structure with its distorted prices and shortages.

Restructuring the economy takes time. It is not simply a Keynesian type problem, to be solved by boosting aggregate demand. It includes the Schumpeterian process of creative destruction: those able to develop new products and apply new technologies to meet demand win the competition, while the losers go bankrupt and exit the market. If the pace of creation is slower than the process of destruction, if new capacities satisfying new demands cannot counterbalance the rapid liquidation of obsolete capacities, the net result is recession. That is what we are witnessing now.

Q. How about the external shock, as the collapse of the Comecon is defined?

A. The collapse of Comecon trade, and especially of the Soviet market, is another crucial factor in the economic demise of the postcommunist nations. Calling it "external shock" is misleading. The collapse of Comecon was part of the overall collapse of communism, very much an internal affair. The Comecon system provided a soft market, always ready to accept the partners' products, competitive or not. The shift from a sellers' to a buyers' market was closely related to the collapse of the CMEA.

Q. What do you mean by "disruption of coordination," and "enforcement of financial discipline," the last two factors on your list of causes of the recession?

A. Many experts had the naive idea that once the command economy was abolished, a market would start to function almost automatically. But one has to recognize that a coordination void develops. This has clearly been the case in the states of the former Soviet Union and in Bulgaria and Albania where the elimination of the old regime was not preceded by a sustained process of economic reform. Hungary, with twenty-five years of reform experiments, has fared much better in this respect, but institution building remains an important condition for further development. For example, the housing industry is still ill-equipped to perform its role as a leading growth sector—it needs a network of real estate agents, developers, contractors, mortgage institutions, and the like.

As to the enforcement of financial discipline and efficiency, the hardening of budget constraints in the state sec-
The wave of bankruptcies, the threats of bankruptcy procedures, and the expansion of the private sector have many beneficial consequences. Nonetheless, in the short term they contribute to the deepening of recession. There is a stronger stimulus, for example, for cost reduction, elimination of excessive inventories, and elimination of “unemployment on the job.” Thus, a wave of new layoffs has begun in Hungary, further contributing to the general contraction. So, yes, privatization ultimately leads to more efficiency, but in the meantime it leads to massive layoffs, contributing to the contraction problem. This process can go even further. According to official data, production has declined faster in the past two years than has employment, indicating that even dying firms have been reluctant to shed their labor.

Q. What is the bottom line of your analysis?

A. If these countries suffered from “conventional” business cycles, they could be cured by standard anticyclical policy, beginning with increasing aggregate demand. There are strong political forces all around Eastern Europe and countries of the former Soviet Union demanding just that. But far from following a regular business cycle, these economies are in a transformational recession. And to emerge they cannot, after the contraction phase, go back to pursuing an expansionary policy and reestablishing old structures to keep alive loss-making firms and maintain obsolete jobs. They must move forward and continue the parallel processes of destruction and creation, eliminating unprofitable product lines and unproductive jobs while encouraging the evolution of profitable ones.

Q. What role would you preserve for the postcommunist government?

A. Hungary and other transition economies cannot rely exclusively on market forces. Private business and the market are still weak, and these countries would likely suffer low-level economic activity and high unemployment—in a word, stagnation. Governments must therefore provide carefully designed recovery packages. These programs must not generate further inflation by injecting more money in the economy; rather, they must focus on stimulating private investment. Specifically, the Hungarian government should:

- Introduce preferential taxes to encourage business investment, including housing development;
- Reduce the heavy tax burden on enterprises once budgetary reform occurs and social institutions are reorganized;
- Develop additional state-owned credit guarantee institutions, thus persuading commercial banks to take more risk while providing long-term investment credit to entrepreneurs;
- Devise fiscal and monetary policy to help bring down interest rates and induce investment;
- Encourage private savers to invest in shares and bonds;
- Accelerate privatization of state-owned companies by providing attractive credits to potential investors. Investment contracts should permit investors to acquire state property, free of earlier debt obligations, contingent on the investors’ pledge to upgrade production and create jobs;
- Ensure early settlement of questionable property rights, including agricultural estates and state-owned apartments;
- Stimulate foreign investment, primarily among investors ready to undertake fixed capital investment, install new technologies, establish new production cultures, and create jobs;
- Promote private sector development by improving telecommunications, establishing industrial parks, and so forth.

Q. You suggested many of these measures three years ago, and some have already been integrated in the government program. Just recently a very advantageous government-guaranteed credit was announced to help small investors in Hungary. Why are you now emphasizing once again this expansionary side of the program? Have you put anti-inflationary efforts on the back-burner?

A. I would not say so, but economic priorities must be considered in the current context, and the anti-depressant cure must be provided without delay. In 1989, I gave top priority to anti-inflationary policy and the servicing of foreign debt. Past events justified that position. Changes in priorities are now necessary. I do not mean a complete U-turn, only a 45° shift. I would not push, for example, for achieving a one-digit inflation rate from the present annual rate, because I think the price would be too high, the present recession would worsen. And we cannot afford that.

My sense is that the people, having experienced economic stagnation and decline for many years, are fed up. Strong popular discontent could endanger the newly acquired liberties of Eastern Europe. We know pre-Hitler German history, the fate of the Weimar Republic following the Great Depression. That depression had a smaller impact in terms of economic decline and unemployment than the present demise of many postcommunist economies.

One cannot formulate policies without taking into account the political mood of the nations involved. Hungary in 1989 enjoyed the first fruits of political change, and a national consensus emerging support of tough economic action. But in 1993, that national consensus seems to have evaporated. Under the circumstances, we cannot risk a high unemployment rate. I am convinced that a reconsideration of economic policy is now essential by the decisionmakers who are responsible for the political future of Hungary and other postcommunist nations.
Economic Guesstimate 1993 for Central and Eastern Europe
PlanEcon is Optimistic, Oxford Analytica is Cautious

The year 1993 will be an average year for Central and Eastern Europe—worse than 1992, but much better than 1994, according to a Hungarian joke. Fortunately, the professional clairvoyants are less gloomy. The Washington-based PlanEcon Research Inc. predicts an economic upturn for Poland, Hungary, and the Czech Republic this year, assuming that those economies have reached rock-bottom in 1992. True, the prospects are bleaker for Bulgaria and Romania, as well as the combatting states of the former Yugoslavia, but—assuming a satisfactory peace settlement among the warring factions there—an upturn of economic activity is expected in late 1994, even in the Balkans. PlanEcon acknowledges that even the best-performing CEE economies would not be able to reach 1987 output levels by 1996. But it questions the reliability of those "pretransition" 1987 figures, and whether output figures can quantify improvements in quality of life, availability of consumer products, elimination of supply-bottlenecks, and the like. PlanEcon's Director, Keith Crane,

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<th>Foreign direct investment in Eastern Europe—less than expected</th>
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<td>Despite a major surge in foreign direct investment (FDI) in Eastern Europe in 1992—total FDI in the region was approximately $3 billion, with two-thirds going to Hungary—the overall level has fallen short of the expectations of most recipient countries and remains below the level required for long-term sustained growth, asserts Oxford Analytica.</td>
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<td>Hungary. The level and structure of foreign investment in Hungary as of 1992 provides some indication that Western companies are starting to consider establishing manufacturing bases in Eastern Europe. Major investors at the end of 1991 were the United States (with investments of about $1 billion), Germany ($500 million), Austria ($325 million), and France ($275 million). Recent official data indicate that the 1991 investment level was sustained in 1992. Total FDI in the first half of 1992 was estimated at $750 million (above the levels for the first half of 1991, but below the levels of the second half), bringing cumulative foreign capital participation in Hungary to an estimated $4.4 billion (or about $500 per person).</td>
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<td>By the middle of 1992 nearly half the 13,500 joint ventures were registered in trade and services. Yet these sectors received only 12 percent of foreign capital invested. Manufacturing, on the other hand, received 58 percent of foreign capital invested but accounted for less than a quarter—only 22 percent—of registered joint ventures. In fact, since 1989 between 65 and 70 percent of foreign investment in Hungary has been concentrated in manufacturing. The bulk of foreign investment in industry has been concentrated in food processing, the car industry, chemicals, electrical equipment, and cosmetics. Investment in manufacturing is highly concentrated, with fourteen companies accounting for 32 percent of all foreign investment. There is a far wider dispersal of ownership in trade and services.</td>
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<td>The Czech Republic and Slovakia. The former Czechoslovakia was the second most successful East European country in attracting FDI. Cumulative FDI by the end of 1992 was $1.0–$1.5 billion. The Czech Republic attracted more than 80 percent of FDI, although it accounts for only two-thirds of the population. Germany is the major investor in the Czech Republic, while Austrian companies are the major investors in Slovakia.</td>
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<td>Poland. Poland has been the least successful CEE country in attracting foreign investment, despite the large number of Polish emigrés who were the major source of foreign investment in 'Polonia' companies under communism. Cumulative FDI in Poland was $1.5–$2.0 billion by the end of 1992. And while U.S. companies are the largest investors in Poland, German firms remain the most numerous. There are some indications that the tide will turn and that Poland will become a major target for Western investors in the longer term.</td>
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<td>Romania. By September 1992 Romania had attracted a total of $500 million in foreign equity investment in 17,143 registered joint ventures. This figure includes investment that has yet to become operational—actual financial inflows associated with joint ventures are probably running at only a quarter of this level (although contributions of equipment and materials considerably round out the investment figure). Oil exploration has proved to be the principal attraction for Western investors in Romania and is responsible for $100 million of investment. Consequently, Holland (Shell), the United Kingdom (Shell and Enterprise Oil), and the United States (Amoco) are the largest sources of foreign capital, with each country investing $63 million, followed by Germany, which has invested $58 million and has the largest number of joint ventures (2,128).</td>
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<td>Bulgaria. Bulgaria has attracted less than $200 million of foreign investment in joint ventures so far, despite its tourist potential. Major factors inhibiting Western firms are political uncertainty, the slow pace of the privatization program, and laws that restore land to former owners, making ownership entitlement extremely uncertain. However, debt-for-equity swaps could boost foreign investment in the future.</td>
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takes a country-by-country look in his forecast.

**Poland.** Last year’s gross domestic product increased by 1.2 percent, and industrial production by 3.5 percent, breaking the downward trend for the first time since 1988. The decline in industrial output, which was the key factor pulling the economy down, began to bottom out in November 1991. And by March 1992 industrial output exceeded levels for the previous year. Construction activity grew strongly throughout the year. Foreign trade also performed well in 1992, with exports rising faster than imports for most of the year, generating a sizable trade surplus and a modest current account surplus. Average economic growth should reach an annual rate of 4 to 5 percent between 1993 and 1996.

**Hungary.** GDP fell again in 1992, but is forecast to grow 4 percent in 1993. Industrial output appears to have hit bottom in May 1992, and by September 1992 surpassed the previous year’s levels. Economic growth is expected to average 5 percent annually over the next four years. The recovery will be driven by increases in industrial output and construction as Western investments come on stream.

**Oxford Analytica: There are grounds for optimism, but...**

Economic performance in Eastern Europe in 1993 will continue to be adversely affected by a combination of internal and external factors, including:

- Deflationary effects of macroeconomic stabilization programs.
- Restructuring of domestic demand following the elimination or reduction of consumer subsidies, which has affected consumption of meat, dairy products, and clothing.
- The potential for industrial unrest, as “hidden” unemployment in heavy industry is converted into open unemployment.
- Loss of markets caused by the recession in Western Europe, and growing calls for protection against East European steel products in particular.
- Deterioration in German economic growth and performance, which would affect prospects for growth of German investment in Eastern Europe.
- Continued deterioration in economic performance in the states of the former Soviet Union and the failure to establish a satisfactory payments mechanism to facilitate trade links between the former Comecon economies.
- The likely spread of the conflict in the former Yugoslavia, with the Balkan economies most seriously affected.

The three-year decline in industrial output and GDP in the three Central European economies (Hungary, the Czech Republic, and Poland) should bottom out in 1993 and be replaced by modest growth later in the year. Inflation for the same period should run at a modest level in the Czech Republic—in the neighborhood of 10 percent annually. Inflation in Poland, however, is expected to continue at an annual rate of 40 to 50 percent. (Editor’s note: Hungary’s inflation rate is expected to reach 15 to 20 percent this year.) But any growth in GDP or even industrial output will be accompanied by substantial growth in unemployment, attributable to industrial restructuring and increased efficiency in the state sector. This will lead to accelerated decline in labor demand and the growth of open unemployment.

The growing number of unemployed will not be able to be absorbed by the growth of demand for labor in the private sector. In all three countries the (estimated) level of industrial employment in the state sector in mid-1992 was 80 to 90 percent of the 1989 level, while recorded industrial output since 1989 had fallen to a low of 55 to 65 percent of the 1989 level. This indicates that, unless there is market growth, there will be a substantial increase in open unemployment before even the 1989 levels of output per worker are restored.

Unemployment in Hungary was estimated to be more than 12 percent at end-1992, and is expected to rise to 17 to 20 percent in 1993. Unemployment in Poland was edging upward to 15 percent at the end of 1992, and could reach 20 percent in 1993.

Continued decline in industrial output and GDP in Romania and Bulgaria is to be expected as the effects of industrial restructuring begin to be felt, with gains from the growth of private sector activity not kicking in until the end of 1993 at the earliest. Romania’s GDP is expected to fall by 8 percent in 1992 and by a further 2 percent in 1993. The decline in output could be more severe in Bulgaria, with GDP falling by 10 percent in 1992 and 3 to 4 percent in 1993. Annual inflation is approaching 200 percent in Romania, and is greater than 100 percent in Bulgaria.

Despite the bleak external conditions facing the East European economies, there are grounds for optimism:

- Signs of a return to more centralized economic models (in the Balkan economies in particular) simply reflect a shift in emphasis in the face of serious economic hardship—not a return to central planning.
- Greater attention and assistance from the West may be expected under the Clinton administration in the United States.
- Trade links with Russia are improving.
- An agreement to improve clearing arrangements between former Comecon countries, supported by the EBRD, should help restore trade links in 1993 and in turn make investment in Eastern Europe more attractive to multinationals.
Czech Republic and Slovakia. Due to differences in economic potentials and likely divergence in economic policies, prospects for an early recovery are brighter in the Czech Republic than in Slovakia. GDP in the Czech Republic is expected to grow 4 percent in 1993, while in Slovakia a 2 percent drop in GDP is likely, with a turnaround expected in 1994.

Bulgaria. 1993 should mark the end of recession and the achievement of a 2 percent growth rate. The optimistic forecast is based, not so much on signs of a solid upturn, as on the assessment that the economy cannot deteriorate any further.

Romania. The economy will probably continue to decline in 1993, with an annual growth rate of 3 percent, before bottoming out in the first half of 1994. An increase in GDP is forecast for 1994 at the earliest. Assuming that the government continues to rely on formal or informal price controls and rationing, little positive supply-side response from the enterprises is expected this year.

Slovenia. A 1.7 percent decline in GNP is expected in 1993, as the country continues to suffer the effects of the Bosnian war. A modest upturn is expected for 1994.

Other former Yugoslav republics. Until peace is restored, these economies will continue to spiral downward. If the war ends with a Serbian withdrawal to Serbia proper, both Bosnia and Croatia will need to repair the damage from the war. Recovery should come quickly as these countries rebuild, although it will take years to return to former levels of output. Serbia, Montenegro, and Macedonia will certainly benefit from an end to the embargo. If the war ends with a Serbian victory, continued widespread guerrilla warfare and endemic political instability might follow, with bleak prospects for economic growth.

What is driving recovery?

In our view, the fledgling recovery could rely on the following factors:

- Entrepreneurs have responded to the new legal framework and freedoms with alacrity. Initially, private firms focused on retailing, services (such as automobile repair), and restaurants; now efforts are shifting to manufacturing, wholesaling, and transportation.

- Foreign investment inflows in kind or cash continued last year and were likely to run well over $1 billion each in Poland, Hungary, and the Czech Republic. Most investments are going into automobile production, food processing, telecommunications, and machine building (especially power-generating equipment). The share of foreign investment in these countries is running at 2 to 6 percent of GDP when converted at market exchange rates—a percentage comparable to Mexico or Malaysia. Direct foreign investment in other CEE countries has lagged because of war, political instability, and financial problems.

- Winners are emerging in state industry, usually in those areas where foreign investors have taken strong interest in starting joint ventures, such as automobiles and food processing. Wood products and metalworking have also done surprisingly well. (But there are also losers. Textiles and leather goods have faced some of the steepest declines in output and will probably not recover because Asian textile producers are likely to capture these markets when demand does increase. Poland, for instance, is now Thailand's second largest market for textiles, after the United States. Producers of hopelessly outdated electronics and precision machinery are also hard hit by the transition.)

- Exports to the West should increase strongly in 1993 as new plants constructed by foreign investors come on stream. Because they are owned and operated by multinationals, these plants should enjoy more stable demand than do traditional exporters.
The danger is certainly there, and it was growing at the end of 1992. The increasing social hardship the economic reform is inflicting threatens both that reform and the fledgling political democracy. It is hardly surprising, therefore, that there are calls for a slower pace of reform that would ease the burden on those millions of East Europeans who are worse off now than under communism. But therein lies one of the great dilemmas now facing Eastern Europe: the longer it takes for living standards to improve, new jobs to be created, and inflation to abate, the greater the risk of political disarray. Political institutions are already in place and competitive politics in operation, however creakily in some places and frenetically in others. Democratic politics are clearly doing better than market economies. But if the latter fail, the former will, too. Political democracy requires a minimum economic sufficiency.

It is not necessarily the case the other way around. There are enough current East Asian examples—not to mention General Augusto Pinochet's Chile for a while—of flourishing, capitalist-type economies cohabiting with partly or profoundly undemocratic political systems. Would the East European countries, or at least some of them, therefore be well advised to cut their losses and settle for this? Or will they be compelled to? It is still too early to say; but the longer it takes the market economy to deliver the goods under democracy, the more attractive the authoritarian alternative will become. Democratic politics would then crumble, and polarization between a noncommunist Left and a neofascist Right would proceed apace. Again, it need not happen. In Poland, the Czech Republic, and Hungary there are real signs of economic promise. Much will depend on how judiciously stick and carrot, shock and therapy are mixed in economic policy.

People will endure much present privation if there is hope of future improvement. But they are getting impatient. The short term is proving too long, and the long term might stretch into infinity.

It is not surprising, therefore, that there is a growing impatience with economic reformers as such. Adapting Clemenceau, many would maintain that the economy is much too important a matter to be left to the economists. They are seen as never fully in control of the forces they unleash, even the best of them little more than sorcerer's apprentices. For Eastern Europe's sake—Europe's too—some of them had better turn out to be right. But it is not only they on whom the burden of decision falls. International organizations are crucially caught up in Eastern Europe's future, and they are understandably worried. But they themselves could perhaps do with a bit more pragmatism in their lending, not to mention a bit more understanding of the history their borrowers are up against.

Many observers see 1993 as the crucial year for several East European countries—make or break; that is, they still give them a chance. But others never gave them any chance from the start. These include the "fundamentalists," who argue that the task of introducing democracy and the market together is just too Herculean. Other schools of thought adduce sociological and cultural arguments to discount the East Europeans' chances, pointing out, for example, that the region has almost no middle class—both the motor and the anchor of modern democracies.

Regarding the future, this argument may be too pessimistic. A large number of entrepreneurs are springing up in Eastern Europe on the heels of the burgeoning new private sector. True, many of them are not quite the solid burghers one has traditionally had in mind when picturing the middle class—law-abiding and dependable, securing the state and forwarding the economy, something from Rembrandt, for example, or out of Thomas Mann. They are more reminiscent of post-World War II London barrow boys, dodging the law rather than deferring to it, here today but not usually in the same place tomorrow, a moving target for the taxman. For them, postcommunist economics is not so much a free market as a flea market. It would be wrong, though, to give up on them entirely. Many of their his-
torical predecessors started off in much the same way. Respectability came later.

"Nomenklatura privatization," however hard to stomach, will also help create a middle class of sorts. Many Sauls are indeed becoming Pauls (with a little financial inducement); the traffic jam on the road to Damascus is getting bigger by the day. Few would have the breathtaking insouciance of a Gaidar Aliev, Leonid Brezhnev's old buddy from Baku: "I was always a democrat," he assured bemused reporters. "You just never noticed." But many are showing an enviable talent for adjustment. And who knows? Many may be as successful in coping with the new mysteries of capitalism as they were in getting around the old idiocies of socialism.

But what about the cultural argument advanced by the doomsayers? This holds, basically, that the communist system has turned most East Europeans into vegetables. No matter how good the new democratic institutions might look, they cannot operate in a cultural vacuum that makes competitive politics, civil society, and economic individualism impossible. This argument has substance, but Eastern Europe since 1989 has been the scene of strenuous activity that belies the image of one vast cabbage patch. The economic activity sometimes amounts to frenzy, and in most countries in the region there is real political liveliness. That some of the liveliness has been of little avail is more the fault of the institutions than of the people.

The best guess is that all the East European nations will shake off the enfeebling legacy of communism much sooner that many expect. They will not shake off this legacy if they become preoccupied with issues that distract and divide, if they are dominated by the past rather than directed to the future. The real political struggle in Eastern Europe today—at least in East Central Europe—is not between "democrats" and "Communists," but between "moderates" and "radicals" in the anticommunist camp, between Girondists and Jacobins, those seeking conciliation and those seeking confrontation.

The "moderates," or "liberals," are generally losing their grip on power and influence. What did these "moderate" figures and forces stand for, and how is their reversal of fortune to be explained? In most cases one answer will do for both questions.

First, they were dissidents. Hence they are part of an era most people now prefer to forget; and they are also, as argued earlier, part of the bad conscience of those who did not resist. (The fact that some of them were disillusioned Communists enables this bad conscience to be dimmed in the vapors of self-righteousness.)

Second, their liberalism on such issues as decommunization, lustration, the rule of law, and societal reconciliation does not sit well with people who either cannot comprehend it or consider it a luxury Eastern Europe cannot at present afford. With regard to Havel, for example, it is precisely his moral standing that is now becoming his political liability.

Third, the sprinkling of Jews in their ranks recharges old prejudices and makes them all fair game for demagogues.

Fourth, many of them, whatever their virtues, have revealed such a practical ineptitude and ignorance of the man in the street's worries that their current limbo comes as no real surprise—except perhaps to themselves.

Nothing, though, has been as calamitous so far as the way nationalism has burst the banks of both orderly government and civilized behavior in parts of the former Yugoslavia; and nothing is more alarming than the prospect of it doing so elsewhere. It is as if Eastern Europe had been under a fire blanket for almost half a century, pegged down mainly by the Soviet Union. Now, with the blanket suddenly removed, old fires that many supposed were long since out are flaring up again, all the more dangerous for their long suppression. The violence, misery, and barbarism in Yugoslavia are atrocious enough, but if they can just be confined to where they exist so far, the rest of Eastern Europe can count itself lucky.

A recent issue (No. 39/92) of the DIW Wochenberichte (weekly report of the German Economic Research Institute, Berlin) discloses startling details of the structural changes and decline in the eastern German economy. Extracting key numbers from the report, a disturbing picture emerges (see table).

A breakdown of aggregate contraction figures into major sectoral changes, shows that GDP for the first three sectors—primarily tradables—declined on average by 61 percent, while the last four—largely nontradables—showed an average decline of 15 percent. Thus the collapse has been heavily concentrated in sectors where competitiveness counts. Furthermore, much of the reduced output of tradables, rather than being consumed internally, was sold to ex-Comecon countries, taking advantage of Hermes' generous export credit financing, (motivated primarily by the German unemployment situation). If, as government sources have indicated, export credit guarantees are drastically reduced in 1993, the level of industrial production in eastern Germany might sink yet further.

The study notes the first signs of recovery in the nontradable sectors. While this spurs growth in local income and employment, the rising income translates into increased demand for tradables. (The ratio of domestic final demand to GDP increased from 98 percent in 1990 to 205 percent in 1992.) The implications are clear: eastern Germany's rising trade deficit with western Germany, which in 1992 was equivalent to 75 percent of eastern Germany's GDP, must be financed through rising transfers. By contrast, the deficit—more than $100 billion in 1992—was only about 6 percent of western Germany's estimated GDP. Clearly, this is not a sustainable recovery and adjustment pattern.

Employment and productivity trends also fall short as signs of early recovery and growth. Employment in eastern Germany declined by 37 percent between 1990 and 1992 (from 9.35 million to 5.86 million)—a greater decline than for overall GDP (-33 percent)—resulting in a 6.6 percent increase in aggregate output per worker over the past two years. That improvement is insignificant, however, when compared with the persistent productivity shortfall vis-à-vis western Germany, estimated at around 60 percent for 1989. Also, in eastern Germany average real wages increased by 94 percent over the past two years, almost doubling the index of unit labor costs, which is now about double the western German level. Even if product quality were to match western German standards and marketing were similarly efficient, rapid de-industrialization of eastern Germany would continue.

Could this rapid erosion of competitiveness have been stopped? Within the same currency area and under realistic assumptions of politically sustainable inter-German wage differentials, comparative advantages translate into absolute disadvantages across the board for the "less developed" region. Equalization of interregional income within, say, one or two decades would require an implausible combination of implausible assumptions:

- A level of productivity growth in eastern Germany never observed empirically except for short periods.
- An extraordinarily high level of grant-type interregional capital flows.
- An elaborate system of subsidies to neutralize the adverse unit labor cost differential during the lengthy adjustment period, in order to ensure voluntary investment in the tradables.

In short, the concern that eastern Germany could turn into Germany's "mezzogiorno" has not been dispelled by the economic developments of the first two years of unification.

The report is surprisingly inconclusive when it comes to answering its own question, "Industrial policy for eastern Germany?" It argues that "efficient structural-regional policy" is an oxymoron, and dismisses discretionary (that is, targeted) capital or labor subsidies. Instead, it opts for applying a uniform investment subsidy—enough to compensate for the relatively high unit labor cost in the "East"—without going into the details of how this subsidy would be financed.

Structural changes in the eastern German economy, 1990-92

<table>
<thead>
<tr>
<th>Major economic sectors</th>
<th>Share of GDP (percent)</th>
<th>Change in output 1990-92 (percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1990 a</td>
<td>1992 b</td>
</tr>
<tr>
<td>Agriculture and forestry</td>
<td>1.3</td>
<td>1.0</td>
</tr>
<tr>
<td>Energy and mining</td>
<td>3.7</td>
<td>3.6</td>
</tr>
<tr>
<td>Processing industries</td>
<td>36.7</td>
<td>35.5</td>
</tr>
<tr>
<td>Subtotal</td>
<td>40.7</td>
<td>24.1</td>
</tr>
<tr>
<td>Construction</td>
<td>7.2</td>
<td>9.9</td>
</tr>
<tr>
<td>Trade and transportation</td>
<td>16.4</td>
<td>16.3</td>
</tr>
<tr>
<td>Other nonstate services</td>
<td>16.4</td>
<td>25.8</td>
</tr>
<tr>
<td>State services</td>
<td>13.2</td>
<td>24.1</td>
</tr>
<tr>
<td>Subtotal</td>
<td>59.3</td>
<td>75.9</td>
</tr>
<tr>
<td>Total GDP</td>
<td>100.0</td>
<td>100.0</td>
</tr>
</tbody>
</table>

a. Data are for the first half of the year.

February 1993
It also leaves up in the air the expected consequences of changing relative cost of labor and capital, as eastern German factor proportions are already considerably different from those of western Germany. On the other hand, the report suggests that Treuhand should sell firms at negative prices if necessary, and that it might even need to offer temporary labor cost subsidies.

The competitive disadvantage of eastern Germany is merely the result of deficient collective bargaining, according to the report, which adds that the state has no obligation to get involved. Rather, its only role should be to remove bottlenecks from the institutional, material, and personnel infrastructure and to deploy conventional instruments of labor market policy. Whatever the theoretical merits of these recommendations, it is difficult to see their political relevance—a government under the intense political and social pressures that come with integrating a “dual nation” is unlikely to survive the adoption of such a timid stance.

**Letters to the Editor**

**Comment of Slovenia’s former deputy prime minister**


First, the authors claim that the political leadership began preparations for establishing a new currency in March 1991. The preparations began in the summer of 1990. The printing of the provisional notes that have been used since October 1991 was, for example, completed before the end of 1990. The fiscal reform was enacted in December 1990—before the arrival of Mr. Pleskovic and Mr. Sachs.

Second, the authors maintain that two other options—the use of a currency board and the introduction of a parallel currency—were considered prior to the introduction of the new currency. In fact, they were designed as a single measure and outlined in the bill, “Introduction of a Parallel Currency,” drafted on February 4, 1991. This was never meant as an alternative to the introduction of a new currency in an independent country. Instead, it was devised to protect the Slovene economy from the effects of a highly overvalued dinar when Slovenia was part of Yugoslavia. The concept was abandoned in favor of a much simpler and less risky concept—the “certificate of import privileges”—which indirectly introduced a flexible exchange rate system in Slovenia alongside the fixed exchange rate system of Yugoslavia. [Editors’ note: Through this scheme, importers in Slovenia were able to overcome the foreign exchange shortage if they were willing to bid and pay the auction price for those certificates, representing foreign currency earned by Slovene exporters and sold to the commercial banks.] The system was used until October 8, 1991 (the day of the currency reform).

Third, the authors claim that the use of a currency board was ruled out because Slovenia had neither foreign exchange reserves nor any kind of external financial support to put the arrangement into practice. Rather, these issues—uneconomic foreign exchange reserves and lack of external financial support—were among the issues of the “pegging versus floating” debate between Sachs’s group and a group of Slovene economists. The latter produced a government document on April 15, 1991, dealing with the macroeconomic issues of independence. It had contemplated most of the scenarios for the October 8, 1991 currency reform, including a rapid—three to five days—conversion of dinars to a new currency at a 1:1 conversion rate, and floating. The Sachs group proposed that the dinar be converted to a new currency at a 1:1 rate and that the new currency be pegged to either the German mark, the ECU, or a basket of currencies to assure a nominal anchor for a shock therapy stabilization program. These views emanated from the Sachs group document, “Program for Economic Sovereignty and Restructuring of Slovenia” (published in March 1991). The Sachs group changed its view in favor of unrestricted floating in their Memorandum of October 8, 1991.

And finally, the authors complain that Slovenia has gone far too slowly with privatization and the financial restructuring of banks and enterprises. They are right. It would, however, be respectable if they reconsidered their role in the stalemate that lasted nearly two years. The tolar is “standing tall” because the independent Bank of Slovenia disregarded the advice of the two advisers to the Slovene government.

**Authors’ response: We still take great pride**

We are amused by Mr. Joze Mencinger’s inaccurate recollection of Slovenia’s monetary reform. In spring 1991, Mr. Mencinger, then deputy prime minister of the economy, lost the support of the ruling democratic coalition because of lack of progress in the area of macroeconomic reform, including monetary reform and privatization, and resigned from his post in April 1991. He did not take part in
subsequent macroeconomic and monetary reforms and was not part of the approach that was implemented.

When we were asked in March 1991 by Prime Minister Lojze Peterle to provide macroeconomic advice to the government, there was no specific economic program for the monetary reform, although provisional notes had been printed for emergency purposes. In our first meeting with Mr. Mencinger and his advisors, Mr. Mencinger described to us a plan to use these notes as a parallel currency to float alongside the Yugoslav dinar. The first major conceptual contribution of Mr. Peterle's team was the suggestion that a clean, one-step introduction of a new convertible currency was feasible, and far superior to the alternative of a parallel currency in which the dinar would have remained in use. Initially, we hoped to peg the exchange rate of the new currency from the time of its introduction, as was later done successfully by Estonia. However, since international recognition of Slovenia came later than had been expected, the country was unable to secure the necessary international lines of credit to build sufficient international reserves to begin with a pegged rate.

We take great pride in the successful introduction of the tolar and the subsequent stabilization of the Slovene economy. Slovenia showed that rapid monetary reform is feasible, and therefore, helped set the stage for the successful monetary reform in Estonia the following year. Moreover, the privatization law that was passed by the Slovene parliament in November 1992 is based on the idea of free distribution of shares that Mr. Mencinger opposed and that Prime Minister Peterle and his economic team championed.

Boris Pleskovic
Jeffrey Sachs

Estonia: it's not a currency board system!

Recently there has been a revival of interest in the currency board system, in part because we, Alan Walters, Milton Friedman, and other economists have advocated currency boards as a solution for the problems of East European monetary systems. Unfortunately, an article by Ardo Hansson and Jeffrey Sachs in the October issue of Transition ("Crowning the Estonian Kron") creates confusion by incorrectly calling the Estonian monetary system a currency board system. In fact, the Estonian monetary system is a central banking system.

A currency board is a monetary authority that issues notes and coins (and, in some cases, accepts deposits) backed 100 percent by assets in a foreign reserve currency. Those liabilities are fully convertible into the reserve currency at a fixed exchange rate. Let us examine how well the Estonian system conforms to this definition:

- The Estonian monetary base is backed 100 percent by German mark assets held by the Bank of Estonia.
- The kroon has limited convertibility for current-account transactions, and is not convertible for capital-account purchases by Estonians. The currency of a currency board, in contrast, is convertible into the reserve currency for current-account and capital-account transactions. A currency board does not try to distinguish between conversions for current-account purposes and exchanges for capital-account purposes; it simply meets all demands to convert its notes and coins into the reserve currency.
- The exchange rate of the kroon is pegged, not fixed. A pegged exchange rate is one that the monetary authority promises to maintain at the current level for some time, but which is not intended to be permanent. A fixed exchange rate is one that the monetary authority cannot change, or at most can only change under well-defined circumstances according to well-specified rules known in advance to the public. Jeffrey Sachs himself has characterized the exchange rate of the kroon as a "peg," and the governor of the central bank has warned that he would have to devalue the kroon if the Estonian parliament approved a high minimum wage. A currency board, in contrast, maintains a fixed exchange rate not subject to devaluation.

Early in 1992, before the Estonian monetary reform occurred, we wrote a short book entitled Monetary Reform for a Free Estonia, which also was published in an Estonian translation. The book explained how to establish a currency board as the issuer of a parallel currency to the tolar. Our proposal motivated the Estonian government, which previously had favored a floating currency, to make the kroon a pegged currency with 100 percent foreign reserves held against the kroon monetary base.

That said, we must stress that the Estonian monetary system does not meet two of the three criteria for a currency board. The Estonian monetary system is a central banking system that has adopted one feature of the currency board system, namely 100 percent foreign reserves held against the monetary base.

The Estonian system should therefore not be classified as a currency board. And when the pegged exchange rate of the Estonian monetary system is altered, as we believe will occur in the near future, the currency board system should not be blamed, since Estonia does not have that.

We advocate a quite different monetary system from the one Estonia now has. We discuss this point further in our forthcoming book, Russian Currency and Finance: A Currency Board Approach to Reform.

Steve H. Hanke (Professor at the Johns Hopkins University), Lars Jonung (Chief Economic Adviser to the Prime Minister of Sweden), and Kurt Schuler (postdoctoral fellow at the Johns Hopkins University)
European Bank for Reconstruction and Development (EBRD)—Second Annual Meeting
April 26-27, London

The two-day meeting of the Board of Governors will be preceded April 23-26 by roundtables and seminars for all participants. Topics include accounting systems and practices in the CEE countries, EBRD’s procurement policies, introducing institutional investors in Eastern Europe, co-financing with export credit agencies, regional environmental programs, Asian models of transition, and unemployment and migration issues in Central and Eastern Europe.

Fifth Annual Bank Conference on Development Economics
May 3-4, 1993, Washington D.C.

Sponsored by the World Bank, the conference traditionally brings together international researchers, Bank staff, policymakers, and development practitioners to focus on major issues in development policy. This year’s topics include: financial policy (R. McKinnon will present a study on financial control of state enterprises in the Russian transition: lessons of the Chinese experience); regulation: principles, capacity, and constraints; the energy sector and the environment; and the economics of regress. Information: The World Bank, Research Administration, Boris Pleskovic, tel: (202) 473-1062 or Gregory Ingram, tel: (202) 473-1052.

How to Fund Exports and Investments to Eastern Europe and the Newly Independent States
May 13 and 14, 1993, New York City

A joint conference of the World Bank and the EBRD. Participants will explore how to tap into $24 billion representing World Bank (IFC) and EBRD contracts in Central and Eastern Europe and the FSU. Representatives from those international finance institutes and U.S. federal agencies, as well as U.S. companies, will speak on procurement procedures and upcoming projects, and will provide lessons of experience. Information: Bill Collins, Conference Coordinator, ITC Consultants Inc., tel: (813) 572-8035, fax: (813) 965-2630.

Sources of Privatization in Eastern Europe
May 21-22, Budapest


Alternative Models of Market Economy in Comparative Economic Studies and Economic Journalism
October 14-16, Poznan, Poland

International conference organized by the Chair of Comparative Economic Systems and Economic Journalism of Poznan, University of Economics, in cooperation with the Friedreich Neumann Stiftung. Participants—researchers specializing in comparative studies and economic journalists from leading Polish and international journals, TV, and radio stations—will discuss postcommunist economic models, and basic differences between U.S., European, and Asian market economies. (Deadline for sending abstracts of papers is May 31.) Information: Professor Ryszard Lawniczak, Poznan University of Economics, Niepodleglosci 10, 60-967 Poznan, Poland, tel: (4861) 699-261, fax: (4861) 668-924.

Nomenklatura entrepreneurs during a business lunch

I would rather survive on bread and water than live under communism

From the Polish economic weekly, Gazeta Wyborca
World Bank/IMF Agenda

Preston on Privatization in the former Soviet Union

World Bank President Lewis Preston, during a visit to Helsinki January 21, said that the creation of a strong private sector is fundamental to the successful transformation of Russia and the other former Soviet states from command to free market economies. Preston noted that a major privatization effort has already been launched in Russia, that most states of the former Soviet Union have made progress in freeing prices, and that a small but dynamic business sector is emerging in Ukraine and other countries. But he also pointed out that stabilization efforts must be intensified; subsidies to public enterprises have to be phased out; and the legal, accounting, and supervisory framework needs to be equitably enforced. Controls on entrepreneurs are still excessive. And a modern banking system—fundamental to a growing private sector—does not yet exist.

Summarizing the World Bank’s efforts so far, Preston pointed out that:

- Three loans to Russia and one to each of the Baltic states have been approved. Lending may reach $2.3 billion by the end of June 1993 and should be higher in 1994—contingent on the maintenance of reforms. But the Bank may not reach this year’s lending target, according to Preston.
- Regional offices have been set up in Moscow, Kiev, and Tashkent, and another is about to open in Riga.
- Consultative group meetings have been held for Kazakhstan and Kyrgyzstan, and preparatory meetings have been held for Azerbaijan, Uzbekistan, and Russia.

Preston called on governments to encourage the new states to remove export controls and to discourage them from creating artificial trade barriers among themselves. He also urged the industrial country governments to keep their markets open to goods from the former Soviet Union.

Michel Camdessus on Russian-IMF Negotiations

IMF Managing Director Michel Camdessus told Izvestiya in Washington, D.C. on February 3 that Russia’s economic program has to be credible not only to the Russian people but to the international community as well. Although Russia has made progress implementing structural reforms, “deficiencies in monetary policy were a key element” contributing to a growing danger of hyperinflation. As a result, Russian authorities “willingly or not destroyed the condition” for receiving the $6 billion ruble stabilization fund. Camdessus noted, however, that if the government produced a solid program for getting its economic house in order, negotiations could begin as early as March for credits totaling $3 billion under a new standby arrangement with the Fund.

Supplementary IDA Credits

Sixteen developing countries that are already implementing IDA-supported adjustment programs will receive additional IDA credits totaling $167.7 million in fiscal 1993. (IDA is the World Bank’s concessional lending affiliate.) The World Bank’s Executive Board approved the funds on January 5. The credits will go to countries that are current in their debt service payments, including Madagascar, Nicaragua, and Tanzania. (The Bank’s fiscal year 1993 began July 1, 1992 and will end on June 30, 1993.)

IFC Pilot Program in Russia—the New “Battle of Stalingrad”

The first wave of mass privatizations is under way in Russia as hundreds of medium and large state-owned enterprises in four oblasts (districts) are auctioned for vouchers under a pilot program developed by the IFC. In the city of Volgograd (the former Stalingrad) a public offer was opened in early February in which about 600,000 shares of twenty large and medium-size enterprises will be sold. Enterprises put on the block have a total capital value of 2 billion rubles and employ 50,000 workers. In total, 200 enterprises will be sold in Volgograd. Similar efforts are under way in the oblasts of Nizhny Novgorod, Tomsk, and Novosibirs. Early results are expected in mid-March. (The IFC has been designing and implementing the voucher auction program, the national share deposit and registry system, and the share trading mechanism. Funding has been provided partly by the U.S. government.)

Mozambique Rebuilds the Maputo Corridor

Mozambique—with partial funding from a $9.3 million credit approved by the IDA (January 19)—will rebuild the country’s most important traffic route, the Maputo corridor. The corridor which extends from the port of Maputo on the eastern coast of southern Africa, serves transit traffic from Swaziland, Zimbabwe, and South Africa. In 1973 the Maputo corridor carried 14 million tons of goods—but traffic has now fallen to about 1 million tons a year.

New Loans for China’s Rural Areas

A World Bank loan of $100 million and a credit of $100 million from the IDA will help control floods and improve land drainage in China’s most industrialized and highly productive agricultural area, the Taihu Basin. The project would also improve the quantity and quality of water for Shanghai and expand and improve inland waterway transportation. The government will receive a further
credit of $115 million from IDA to increase agricultural production and farmers’ incomes by strengthening institutions that provide support services to farmers.

**173 Member Countries in the World Bank**

The Czech Republic and Slovakia became members of the World Bank on January 1, 1993, assuming the membership of the former Czechoslovakia. (The states also became members of the IDA and the IFC.) The World Bank now has 173 members, the IDA 148, and the IFC 150. Since 1991, the IBRD has approved loans totaling $696 million for development projects in the former Czechoslovakia.

**IDA Credits to Revive Albania’s Villages...**

IDA approved a $2.4 million credit to Albania for the first-year pilot phase of a new four-year $36 million plan to bring the country’s crucial rural economy back to life. Albania’s rural areas will be revived under the plan with help from a new rural development fund. The fund will enable the government to make small loans to rural entrepreneurs and farmers and will offer grants to local communities for rural works projects. Loans from the fund will range from $20 to $500 and will enable rural workers to set up new small-scale businesses or buy livestock.

...and Rural Banking in Madagascar

An IDA credit of $3.7 million will help the Madagascan government launch a project to support a new savings and loan movement at the grass-roots level in rural areas. The project would extend financial services on a sustainable basis to roughly 10,000 farm families.

**Milestones of Transition**

The London-based EBRD, set up two years ago, plowed $240 million in cash into Central and Eastern Europe last year, while commitments for project investment over the period totaled $1.4 billion. Poland and Hungary account for 44 of the 71 projects approved so far. Russia accounts for eight projects. This year the EBRD plans to approve some 100 additional projects representing total investment commitments of $3.1 billion. Related investment to EBRD-backed projects by other organizations, governments, and private investors should total nearly $40 billion.

The free trade agreement between Hungary, the Czech Republic, Slovakia, and Poland (unofficially CEFTA, for Central-European Free Trade Agreement), effective March 1, 1993, foresees a removal of national trade barriers between the signatories by 2001 and mutual trade guided by terms similar to those that apply to their bilateral association agreements with the European Community. Industrial tariffs applied in interregional trade will be abolished by January 1, 2001. Tariffs on products considered “particularly sensitive items,” such as steel, cars, and textiles, will be eliminated late in the period, between 1997 and 2001. Tariffs on agricultural products will be lowered by 50 percent during the next five years.

Thirteen of the 15 states of the former Soviet Union signed an agreement to create a Council of Heads of Government on Oil and Gas with a secretariat in Tyumen, Siberia. The accord, which also calls for creation of a bank to finance energy sector investment, aims to halt Russia’s collapsing oil production and ensure adequate supplies to areas suffering shortages. Turkmenistan and Latvia were absent from the meeting in Surgut, Russia. Kazakhstan’s Prime Minister Sergei Tereshchenko told reporters the accord was a beginning that could lead to the creation of a mini-OPEC.

According to Interfax news agency, planned exports of Russian oil and gas in 1993 are as follows (1992 exports are in parentheses): to former Soviet republics, 56 million tons of oil (87.6 million tons) and 97 billion cubic meters of gas (109 billion cubic meters); to other countries, 40-45 million tons of oil (66 million tons) and 109 billion cubic meters of gas (99 billion cubic meters).

Effective January 1, 1993, Russian enterprises in all branches of the economy have been freed from taxes on the money they channel into investment or into expansion and renovation of production capacities. Value added tax rates have been reduced from a uniform 28 percent to 10 percent for foodstuffs and children’s products and 20 percent for the rest. The same rates will apply to imported goods. Income declarations are now mandatory for the estimated 10 million citizens whose total annual income exceeds 200,000 rubles. The first deputy head of the State Taxation Service recently outlined these changes in Russian tax laws.

Hungary’s Central Statistical Office reported in February that on average 1,100 new companies started business every month in 1992. The number of individually owned private compa-
Bulgaria’s balance of payments in 1992 ended with a surplus of $451.6 million. According to the Bulgarian National Bank—which compiled the figures—foreign trade revenues accounted for the bulk of the surplus. Because of the drastic increase in imports during the second half of 1992, however, the current trend is negative. In all, Bulgaria imported $4,608 million worth of goods in 1992 and exported $5,093 million.

The Kazakh parliament approved a 1993-95 economic program calling for a sharp reduction in inflation, halting the drop in production, and narrowing the budget deficit to 3 to 5 percent of GNP this year.

Romania’s fast-growing private sector, concentrated in trade and services, contributed more than 25 percent to gross domestic product last year, says the National Statistics Commission’s report. The 400,000 private companies and business people registered since 1989 handled 32 percent of imports and 26 percent of services last year, doubling their share of retail sales to 45 percent. But private sector growth failed to offset the continuing state sector decline, with GDP falling about 15 percent to $510 per person. Finance Minister Florin Gerogescu said Romania’s 1993 budget deficit is $504 million on spending of $5.1 billion, assuming an exchange rate of 500 lei to the dollar.

China’s Deputy Finance Minister Xiang Huaicheng said the solution to his government’s financial problems lies in improved efficiency in state enterprises, large reductions in administrative costs, and bolder financial reforms. The 1992 budget deficit will be slightly less than the forecast 20.7 billion yuan (after 21 billion in 1991). Subsidies to large and medium-size enterprises cost 50 billion yuan in 1991, and there was little improvement in 1992. Xiang said government income as a proportion of GDP was declining, reducing its dominance over the economy. Government revenue for 1992 is expected to rise at most by 10 percent over 1991’s 358 billion yuan, with economic growth at 12 percent.

Liu Minxue, chief of the Chinese Administration for Industry and Commerce, said private businesses “will be allowed to engage in production and management in almost all industries except those concerned with national security and health.” The new policies would apply to an estimated 15 million household and private enterprises, which paid state taxes of about $3.5 billion last year. The state would encourage the private sector to develop cooperation arrangements with other types of enterprises.

New Books and Working Papers

The CECTM unit of the World Bank regrets that it is unable to supply the publications listed.

Recent World Bank Publications

Poland: Income Support and the Social Safety Net during the Transition

The study is based on the findings of World Bank missions that visited Poland between 1989 and 1992. Its short-term recommendations for reforming the cash benefit (social security minus health) system of Poland include the following:

- Poverty relief—For example, the minimum level of unemployment benefit, or wage, should be high enough to support a single individual; income-tested social assistance should be high enough to support families. In-kind benefits should be limited, the benefit system closely monitored).
- Cost saving—New entrants to the labor force should be potentially eligible for social assistance but no longer entitled to unemployment benefits; workers’ social insurance contribution to be divided between them and the employer. Family allowance to be reduced in real value while supplemented with income-tested family support.
- Improved labor market incentives—In late 1991, standard unemployment benefits have been reduced to 36 percent of the average wage, but sick pay is still 100 percent for many recipients. Sick pay after several weeks should be financed by the social insurance fund, not the employer.
- Administrative reform—The large numbers of unemployed could be better helped by
strengthening the regulatory framework and streamlining the assessment procedure.


Both the above publications are available at the World Bank bookstore, or to order: World Bank Publications, telephone: (202) 473-8010, fax: (202) 473-9075.

To order Aludia Oropesa, The World Bank, Room 11-017, telephone: (202) 473-8010.


Both the above publications are available at the World Bank bookstore, or to order: World Bank Publications, telephone: (202) 473-8010, fax: (202) 473-9075.

Policy Research Working Papers

Branko Milanovic, Distributional Impact of Cash and In-Kind Social Transfers in Eastern Europe and Russia, World Bank, Washington, D.C., 1992, 43 p.

To order: Grace Sorensen, The World Bank, Room N 11-017, telephone: (202) 473-9019.


To order: Rose Vo, The World Bank, Room S 8-042, telephone: (202) 473-1047.

Cevdet Denizer and Alan Gelb Mongolia: Privatization and Sys-

Recent CEPR Publications

Discussion Papers


The economic cost of German unification has exceeded all expectations. Output and employment have fallen sharply, as has occurred elsewhere in Eastern Europe. A development unique to Germany, however, has been a wage explosion. Workers in eastern Germany demanded equal wages for identical jobs, regardless of productivity. The German government relented, because of political pressures and to avert massive East-West migration.

As a result, the flow of government assistance to the three states (Länder) of eastern Germany totaled DM150 billion in 1991 alone. Two-thirds of that transfer went to consumption, only one-third to investment. Further "off-balance-sheet" transfers went through Treuhandanstalt (THA), for guaranteeing commercial bank loans to state-owned firms; it is estimated that THA debt will rise to DM250-DM300 billion by the mid-1990s.

The paper proposes a simple, uniform, universal wage subsidy in the East, assuming that a significant productivity gap between Germany's two halves will persist for several years. In the kickoff year of the program, the government should finance 75 percent of eastern Germany's total wage bill, cutting gradually to 50 percent the second year, 25 percent the third year, and no subsidy thereafter.

This proposal would stimulate current employment without significantly distorting longer-term investment calculations, argue the authors. Furthermore, it is easy to monitor, and the phase-down is sufficiently fast to prevent distorted investment decisions. The budgetary cost of the...
proposed wage subsidies could be re-couped as unemployment payments decrease, as revenues from taxing business profit, incomes, and sales (VAT) increase, and as Treuhand’s sales revenue expand. The fear that wage subsidies will elevate wages is unfounded under this proposal; excessively high wages could lead to eventual job losses, claim the authors.


To oversee all U.S. assistance efforts in the region, a high-level policy and program group should be given real authority within the U.S. government. To avoid duplication, the U.S. should promote coordination of Western and Eastern efforts in multilateral institutions and encourage structured dialogue and priority setting, focused for now on the challenges of state enterprises and regional development. Assistance should be centered on labor-intensive projects that provide employment, relieve social distress, and develop needed infrastructure, and on technical assistance to develop social safety nets and job retraining programs and to increase labor mobility. This could help alleviate the substantial, politically unacceptable unemployment created by dismantling the large-scale state-owned enterprises.

Central and East European governments should be encouraged to identify areas of common concern in which they could work together, such as environment and transportation. Such cooperation need not compromise their desire to join the European Community, nor should U.S. support for regional cooperation of this kind be perceived as intending to keep them out of the Western club. They should be encouraged to reestablish linkages with nations of the FSU. Regional cooperation could be essential for creating markets for the products of privatized state enterprises.

The United States should seek improvement of government-to-government “umbrellas” for investment, especially facilities for securing investment financing and guarantees. Removal of restrictive U.S. conditions on commercial financing (the 40 percent reserve requirement) would free additional resources. Debt rescheduling should be committed to by the West, and market barriers should be eliminated: debt burdens and limited Western market access pose serious obstacles to Central and East European growth and the ability of new private enterprises to compete.

To order the above papers: CEPR, 25-28 Old Burlington Street, London W1X 1LB, tel: (4471) 734-9110, fax: (4471) 734-8760.

Other Recent Publications

The Atlantic Council of the U.S., *Central and Eastern Europe: Unfinished Revolutions* (Co-chairs: Rozanne L. Ridgway and John F. Hardt)


Faced with the collapse of traditional markets in the East, limited access to Western markets, deep recession, and domestic political disputes, the economic performance of Central and Eastern Europe has fallen far short of popular expectations of rapid change, and the promised prosperity from market transformation appears distant. Failure to complete the revolutions is likely to make the Central and East European countries more vulnerable to the virulent “Balkan disease” now being played out in Yugoslavia and to create a region of poor, uncertain, complicated societies ready for victimization by internal or external forces.

Dismantling the old state enterprises should be supported by Western assistance programs. However, economies in recession and domestic priorities in the United States and Europe will continue to limit the additional resources available for Central and Eastern Europe, making a large infusion of Western bilateral official funds unlikely. In the long term, the answer is private investment and entrepreneurship. In the short term, strong U.S. leadership is essential to bring together Western donors and Central and East European leaders to focus on critical tasks.


M. Uvalic, J. Lorentzen, and E. Espa, eds., *Impediments to the Transition in Eastern Europe*, European
Working Papers of the Institute for World Economics, (Hungarian Academy of Sciences), Budapest:


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