Education and Information are Fundamental to Success
World Bank President James D. Wolfensohn Visits Russia and Eastern Europe

The World Bank's newly appointed president, James Wolfensohn, seeking firsthand knowledge of the Bank's member nations and of the specific problems in their regions, visited Africa, the Middle East, Latin America and most recently five transition economies: Russia, Hungary, Albania, Uzbekistan, and Ukraine. After his latest trip a "town hall meeting" was organized with World Bank Staff of the Europe and Central Asia Region. Here follows a shortened version of his remarks during that meeting.

Dealing with the social issues of transition is of tremendous importance. A terrible anxiety has developed as the economic underpinnings of these countries' social policies have become uncertain, or even disappeared. These nations—in contrast to those in Africa, Latin America, and the Middle East, which I had visited earlier—maintained full employment, as well as a social safety net that includes health care, education, and retirement benefits. Maybe it was inefficient, maybe it was unsustainable, but it was there. Other regions never had that social support system. In the Donetsk region of Ukraine, 450,000 jobs depend on coal mining. Miners work under dismal conditions straight out of the nineteenth century: in lanes less than a meter wide, running at a 30-degree angle, with obsole-...
closing twenty of the mines. Clearly an economic and humanitarian case can be made for that, but what of the mines' employees? At least now they have a job, even if it is not a good job. At present the World Bank is working on a pilot program of $10 million to close three mines and retrain the redundant workers. It will mean moving from a socially secure, but economically inviable activity into a market-oriented activity with fewer social guarantees. Many governments are not prepared to borrow for social purposes. And yet, without adequate social underpinnings, advances on the economic front may seem of dubious value to the average citizen and the risk of political tension may increase.

I was impressed by the high level of education and the tremendous desire for information and knowledge in the region. Dissemination of ideas, information, and education are fundamental to the success of transition. Accordingly, a substantial upgrading of the training and education activities of the Bank's Economic Development Institute (EDI) needs to be considered. The Bank also needs to communicate better with the public both by examining its wide range of activity and by listening to suggestions.

In Nizhni Novgorod I saw a farm that the IFC is helping to privatize. This is a wonderful experiment—but it is still an experiment. The Bank can take three coal mines and deal with their social problems. Or the Bank can go to an auto or a tractor plant, and with some money, demonstrate that the local government can take over administration of the kindergarten or the housing projects that were the responsibilities of those firms. But whether it is privatization of farms or removal of social programs from inefficient corporations—the question is, how can we broaden these good examples so that they can become systematically effective? The Bank can fund excellent pilot projects, but the systemic extension is what it really has to strive for—finding solutions to social issues, together with the host governments. This will certainly require a level of involvement by the government that goes beyond the simple funding of projects.

In Moscow World Bank loan disbursements were a major focus of discussions with Prime Minister Victor Chernomirdin and his first deputies, Mr. Chubais and Mr. Sokovets. Commitments to Russia have totaled $4.6 billion so far, but with the exception of about $1.2 billion in fast-disbursing loans, disbursements have amounted to a mere $200 million. The backlog is enormous. Something is not clicking, and agreement was reached with Mr. Chubais to review all the projects in six months. We will check whether there are problems that can be fixed on our side or on theirs to improve monitoring of the operations. A six-month review, at a very high level, was also agreed upon in both Hungary and Uzbekistan.

A meeting with leading economists at the Budapest Institute for Advanced Studies, hosted by Professor Janos Kornai, proved a very useful introduction to issues in Hungary. I was impressed by the progress that Hungary has made, although with large fiscal and external deficits it still has a long way to go. The 1996 budget will be critical. Prime Minister Gyula Horn backs the tough stabilization program devised by Finance Minister Lajos Bokros and National Bank President Gyorgy Suranyi, despite the apparent social tensions. The World Bank is being called upon to finance transition costs related to social sector, public sector, and financial sector reforms. This request will pose a real challenge for the Bank. I was happy to visit MATAV, the Hungarian telecommunications company, in which both the World Bank and the IFC have invested.

In Albania the World Bank has had great success: in three years 45 percent of the portfolio, consisting of eighteen projects, has been disbursed. Traveling around the country reaffirmed my faith in villages. We went to a mountain village to look at a microenterprise. The villagers were concerned that our loans were small—only up to $500—and they asked for $5,000. "Can you get this?

### World Bank Lending to Russia, 1993-October 1995 (US$ million)

<table>
<thead>
<tr>
<th>Date</th>
<th>Loan Description</th>
<th>Amount</th>
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<td>First rehabilitation loan</td>
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<td></td>
<td>Employment services</td>
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<td></td>
<td>Privatization</td>
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<tr>
<td></td>
<td>First oil-rehabilitation loan</td>
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<tr>
<td>1994</td>
<td>Road repair</td>
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<tr>
<td></td>
<td>Development of financial institutions</td>
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<td></td>
<td>Land reform</td>
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<tr>
<td></td>
<td>Enterprise restructuring</td>
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</tr>
<tr>
<td></td>
<td>Second oil-rehabilitation loan</td>
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<tr>
<td>1995</td>
<td>Environmental-management loan</td>
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</tr>
<tr>
<td></td>
<td>Financial and managerial training</td>
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</tr>
<tr>
<td></td>
<td>Project portfolio loan</td>
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</tr>
<tr>
<td></td>
<td>Housing project</td>
<td>400</td>
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<tr>
<td></td>
<td>Modernization of tax service</td>
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<tr>
<td></td>
<td>Emergency oil pollution cleanup</td>
<td>99</td>
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<td></td>
<td>Gas transport network</td>
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<td></td>
<td>Urban transport</td>
<td>329</td>
</tr>
<tr>
<td></td>
<td>Second rehabilitation loan</td>
<td>600</td>
</tr>
<tr>
<td></td>
<td>Total</td>
<td>4,641.5</td>
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</table>

amount from another bank?"—I asked them. And they said, "No, we like you, we are very loyal to the World Bank." They vehemently denied that it had anything to do with rates.

In Uzbekistan our trip to the Aral Sea was perhaps one of the most moving experiences. We went to a fishing village, now some 40 kilometers away from the coastline because about 3,400 square kilometers of sea have dried up since 1960. In the Soviet era, irrigation systems, fed by rivers that flow to the Aral deprived the sea of water. The challenge for us, together with the five governments of the Aral Sea Basin, is to stabilize the situation—so that degradation of the Aral Sea can be arrested—and to do something for those villages that have been left behind by the receding water. These people’s traditional skill is fishing and fish processing. The Bank has participated in creating wetlands with fish cultivation. In this village where people had absolutely nothing, a child came up to me and gave me five sums, about ten cents, because the tradition is to give travellers some money for the rest of their trip. It was a moving moment that revealed that the strength of spirit and the values of the local people, at the village level endure—it is important for us to build on these strengths. In many countries that I visited, the IFC office is at one end of town and the World Bank office is at the other. This is more than symbolic. In the realm of ideas and operations, IFC and the Bank often function as independent units. Independence is a good thing, but within the World Bank Group, the relationship needs to be that of best friends working together. I do not propose to merge either IFC or MIGA; but there is a need for better coordination within the World Bank Group especially dealing with the private sector.

**East of Eden**

"... You may stay, if you buy it ..."

From the *Hungarian Economy*
From Plan to Market: Patterns of Transition
by Martha de Melo, Cevdet Denizer, and Alan Gelb

Formerly communist countries are moving along the transition from a planned to a market economy with different speed. This article compares the progress made by individual postcommunist countries in liberalizing their economies. It concludes that economic liberalization, the cornerstone of early reforms, interacts strongly with growth and inflation. The higher a country's liberalization index, the better chance it has to speed up growth and check the inflation rate. The close relationship between economic liberalization and political freedom helps to explain why some countries moved quickly on reforms and others did not.

Liberalization leads to stabilization in a way that is not self-evident to those policymakers who are accustomed to socialist pricing and output conventions. For example, the attempt to maintain employment and output by fiscal and quasi-fiscal transfers to enterprises results in larger output declines than a policy of hard budget constraints introduced along with economic liberalization. Also, liberalization of prices results in lower inflation than do continued price controls.

Twenty-six countries of Central and Eastern Europe (CEE) and the former Soviet Union (FSU), as well as Mongolia, are analyzed in this article. China and Viet Nam—although distinct in many respects—are also included in the analysis for comparative purposes. The period covered is 1989 through 1994. The starting point is 1989, a pivotal year in the transition from communism to a market economy.

Measuring Liberalization

In order to explore the broad cross-country relationships between growth (annual changes in real, officially measured GDP), inflation (average annual changes in the consumer price index), and liberalization, the authors construct an annual liberalization index (LI) for each country over the 1989-94 period. This index—ranging from 0 to 1—classifies countries into different reform groups (advanced, intermediate, slow, and affected by war and embargoes). China and Viet Nam make up a separate, Asian country group. The index measures the progress of these twenty-eight economies in three areas:

- **Liberalizing internal markets** (freeing domestic prices, abolishing state trading monopolies).
- **Liberalizing external markets** (easing the foreign trade regime, including the elimination of export controls and taxes; currency convertibility).
- **Facilitating private sector entry** (privatizing enterprises, reforming the banking sector).

To indicate the duration and the intensity of reforms from 1989 onward, and factor in the institutional and other changes stimulated by prior policy reforms, a Cumulative Liberalization Index (CLI) has been developed, adding up the annual liberalization indexes of each country over the six year period. (It is interesting to note that the 1993/94 liberalization indexes of China and Viet Nam are lower than those of the advanced reformers, but their CLIs are rather high, reflecting the early introduction of important reforms.)

Liberalization—Stabilization—Recovery

The table on page five shows four country reform groups based on the CLI, plus countries affected by war and China and Viet Nam. Statistical analysis of the CEE and FSU countries indicates that cumulative liberalization has a positive effect on output changes within the overall context of a "transitional recession." Moreover, output recovery appears to require inflation to fall to more moderate levels—at least to less than 100 percent a year. Both advanced and high intermediate reformers had stabilized or returned to positive real GDP growth by 1993-94, but slower reformers continued to experience major output declines.

An important reason for the association between liberalization and recovery is that capital and labor are able to flow from industry toward services, and economic growth can be fed by the expansion of previously repressed service sectors.

Analysis also supports the view that liberalization has been a crucial element of stabilization policy, even though its initial impact entails a spurt in prices, and even though it is by no means a sufficient condition for regaining stability. CEE and FSU countries that failed to liberalize experienced far higher inflation over the 1991-94 period than those that did liberalize. An important explanation is that liberalization makes the introduction of hard budget constraints—and hence fiscal and monetary restraint—more feasible by providing appropriate signaling of the costs and benefits of specific restructuring measures.

Democracy Nurtures Liberalization

What then determines the pace of liberalization? By matching country rankings of the cumulative liberalization index to a comparative index of political rights and civil liberties (Comparative Survey of Freedom for 1994, compiled by the Freedom House, New York), it is found

November-December 1995
**Transition**

**Liberalization, Growth, and Inflation, 1989-94**

<table>
<thead>
<tr>
<th>Group</th>
<th>Country</th>
<th>CLI</th>
<th>Liberalization Index (CLI)*</th>
<th>Inflation rate (89-94)**</th>
<th>Growth rate (89-94)**</th>
<th>89/94 GDP (89/94)**</th>
<th>Lowest yearly GDP/89 GDP (%)</th>
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<td>1.7</td>
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* Average of 1993 and 1994 combined.

Source: the authors.

**Cumulative Liberalization—Cross-Country Indexes**

Countries of Central and Eastern Europe, Mongolia, as well as those of the former Soviet Union, are listed and grouped into four categories according to the magnitude of their cumulative liberalization index (CLI):

1. **Advanced reformers** (CLI greater than 3): Slovenia, Poland, Hungary, Czech Republic, Slovakia.
2. **High intermediate reformers** (CLI less than 3, but greater than 2): Bulgaria, Estonia, Lithuania, Latvia, Romania, Albania, Mongolia.
3. **Low intermediate reformers** (CLI less than 2, but greater than 1.3): Russia, Kyrgyzstan, Moldova, Kazakhstan.
4. **Slow reformers** (CLI less than 1.3) Uzbekistan, Belarus, Ukraine, Turkmenistan.
5. **CLIs vary in a fifth category of countries affected by war: the former Yugoslav and Soviet republics that have experienced major and persistent internal conflicts during 1989-94 or, in the case of Armenia and FYR Macedonia, have been subject to conflict-related blockades.
6. **A sixth category comprises East Asia's two socialist economies, China and Viet Nam.**

That economic liberalization is typically associated with a similar degree of political change. The direction of causality is actually two-way, since economic liberalization is an essential step in breaking the power of established structures, especially line ministries that previously controlled industry and trade.

In CEE/FSU countries where former communist party leaders have held power continuously (Kazakhstan, Turkmenistan, Ukraine, and Uzbekistan), reforms have been slow and driven largely by macroeconomic pressures arising from the breakup of the Soviet Union and attempts to maintain the status quo. Those countries that made a clear break with the previous regime (the Czech Republic, Hungary, Poland, Estonia, Latvia, and Lithuania) have radically liberalized. The process has continued even though several postcommunist parties won in the last parliamentary elections (in Hungary, Poland, Estonia, and Lithuania). To date no attempts have been made to backtrack on liberalization policy.

Developments in China and Viet Nam appear to contradict the link between political and economic reform. The countries have liberalized economically while retaining strict controls on political rights and civil liberties. But in China political power was decentralized to provincial and local governments, and this has played an important role in economic liberalization since the start of agricultural reforms in 1978. In Viet Nam the 1989 "renovation" reforms were followed by implicit decentralization of economic decisionmaking through emphasis on initiative at the local level. In both cases the East Asia model of gradual, decentralized economic transition appears to have a political counterpart, even if it is not political freedom per se.
Political Freedom and Economic Liberalization in CEE/FSU, 1994

Index of Political Freedom

* Shown for comparison only.
Source: Freedom Review, January 1995, Authors

Policy Implications

The above conclusions have several implications for recent policy debates:

- **Rapid reforms are preferable.** The close relationship between economic liberalization and political freedom more or less determines the reform policy of a given regime. To the extent that regimes do have options, however, rapid reform is preferable to slow reform, given the breakdown in the central planning apparatus. The status quo was not a viable option for CEE and FSU countries. Recorded inflation and output losses in countries that have managed to postpone adjustment are now far larger than in the more advanced reformers.

- **Stabilization is a priority.** There are strong interactions between liberalization, stabilization, and growth. Neither the effective functioning of markets nor renewed investment is possible with severe macroeconomic price instability; thus, stabilization becomes a priority for the resumption of growth. Without liberalization, subsidies and budget deficits cannot be eliminated, which in turn means continued lax fiscal and monetary policies. No country was able to return to positive growth without liberalizing first.

- **Fiscal constraint is required.** The transition recession and lags associated with the introduction of a new tax system typically lead to declining revenues in transition economies, while social expenditures are expected to increase. Nevertheless, in economies of advanced reformers, fiscal revenues and expenditures have tended to remain high relative to GDP, while fiscal deficits have been noticeably smaller than in those countries that delay reforms.

However, this does not mean that privatization of state enterprises which make up the traditional tax base, should be delayed. With the shift of structural demand and large changes in relative prices, many state enterprises have become losers, without any taxable profit anyway. On balance, even if there are reasons—cultural, institutional, or structural—why the fiscal position is stronger in advanced reformers, there is no convincing evidence that a slower pace of reform has strengthened the fiscal position of intermediate and slow reformers.

- **Anchor: money supply or exchange rate?** Either a money supply anchor or an exchange rate anchor have been used in stabilization programs, often in combination with restrictions on public sector wages. Either approach can be effective, although the choice is likely to depend on the volatility of money demand, the adequacy of foreign reserves, and the effectiveness of the anchor in establishing credibility. The implications of the findings here are that any stabilization effort—whether exchange rate-based or money supply based—should be preceded by wide-ranging liberalization schemes, given their favorable impact on efficiency and credibility.

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Russia Fights Crime and Corruption

By Michael Gray

Although a strong entrepreneurial spirit continues to flourish among legitimate business people in Russia, organized crime and public corruption are menacing businesses throughout the country. An increasing number of legitimate businesses—in practically every part of the Russian economy—are being blackmailed, forced out of business, or simply taken over by criminals and corrupt government officials.

Slow Legislation

Enacting criminal justice legislation in Russia would establish an effective system of commercial and criminal laws, help to protect businesses from organized crime and corruption, and provide a needed framework for establishing the rule of law in Russia. But it is proving to be a slow and difficult process. Lawmakers apparently cannot agree on the scope of proposed substantive legislation or even whether substantive or procedural reform should be given priority. For example, the draft penal code, after being rejected by the Federation Council (Russia’s senate), was passed again by the Duma with sufficient votes to override the Federation Council, only to be vetoed by President Yeltsin, who wants a criminal procedure code further developed first. A separate draft law on organized crime that includes important provisions for combating crime and money laundering was also rejected by the Federation Council in October.

A proposed law on money laundering is also encountering delays because of a lack of consensus among potentially affected government agencies. Revisions to these draft laws, and other important pieces of criminal justice legislation including a draft code on criminal procedure, will now depend on the attitude of the new parliament elected on December 17th.

The current draft penal code outlaws securities fraud and money laundering and forbids “false” and “fraudulent” bankruptcies. The drafters, however, are obviously having difficulty deciding whether certain “harmful activities” should be deterred by civil damages or criminal penalties. “Illegal use of trademarks,” for example, is considered a crime under the draft. In the United States this activity is generally addressed by civil prohibition rather than criminal sanction. Similarly, Russian lawmakers branded “negligent destruction of property” as a crime, which in the United States is generally addressed in the civil law context whereby the injured party can sue the person who destroyed the property and recover damages. The Russian draft penal code also proposes criminal sanctions against government officials who obstruct “legitimate entrepreneurship.” These actions, however, may be better addressed through disciplinary proceedings within such officials’ agencies, or through a civil suit by the aggrieved party.

Drafters could, more clearly, coordinate the creation of criminal prohibitions and civil causes of action. For example, the draft penal code criminalizes false bankruptcies (as in the United States). Yet it has not been clarified how these new criminal provisions and the civil provisions of the Russian bankruptcy law will be squared. Similarly, money laundering provisions in the penal code should be coordinated with those in the proposed law on money laundering. Because of the vague definitions and scope of these crimes, some legitimate business transactions may actually be inhibited out of fear of risking criminal sanctions. It is important to note, however, that a commentary which typically accompanies laws may alleviate many of the problems associated with the lack of clear definition of what constitutes illegal conduct.

Prohibiting Money Laundering

Money laundering is linked to other criminal activity, such as drug smuggling or bank fraud. The Russian MVD (Ministry of Internal Affairs) currently estimates that more than 3,000 criminal groups, using threats and blackmail, have established control over 40,000 businesses, including more than 400 banks, nearly 50 stock exchanges, and almost 1,500 enterprises in the government sector of the economy. The draft Law on Liability for Legalization of Proceeds of Crime, (the proposed law on money laundering), contains many important provisions that not only prohibit money laundering but also attempt to create a structure permitting effective enforcement of the law’s prohibitions. However, the law could be improved by clarifying its terms. For example, the draft law prohibits acts designed to conceal the source of funds obtained through “criminal activity,” without defining the term, criminal activity. Also, the draft law does not prohibit a person from using funds derived from a criminal act, even if the person is aware of the origin of these funds.

The draft law also requires financial institutions to submit currency reports and record all significant financial transactions in a manner that fully identifies the person or business involved in the
The legislation requires financial institutions to report suspicious financial transactions to governmental authorities within twenty-four hours. Yet terms such as "financial institution" and "financial activities" and "transactions" are not clearly defined. The term "financial institution" appears to be limited to banks, and thus does not include other businesses that receive large sums of money in exchange for goods and services, such as automobile dealers or dealers in precious metals. Nor does it seem to encompass other financial service businesses, such as insurance and credit card companies. (In the United States such companies are required by law to file currency transaction reports.) "Financial institution" may thus include any business whose cash transactions could be used to launder money.

The draft law also requires financial institutions to unilaterally refuse to implement financial transactions if they are either "suspicious" or "economically inexpedient." Yet neither "suspicious" nor "economically inexpedient" is defined by the law. The draft law would thus grant significant discretion to financial institutions to determine which transactions are "suspicious" or "economically inexpedient." It could therefore be disruptive to the financial system, actually promote corruption in the banking industry, and hinder legitimate business activity. It would be preferable to require financial institutions to report all suspicious transactions (with "suspicious" clearly defined by the law) to an appropriate government agency, while employing safeguards to ensure the confidentiality of information reported.

The draft law further requires financial institutions to report to the government any single cash transaction that is more than 200 times greater than the minimum wage and any single noncash transaction that is more than 500 times the minimum wage. Yet the law neither prohibits the structuring of financial transactions to avoid these restrictions, nor requires institutions to report transactions that, if deposited in aggregate amounts within a twenty-four hour period, will reach these same levels. It is important to note that a commentary that typically accompanies the law, may (1) clarify which, if any, structured transactions, are in fact bogus, and thereby must be reported, and (2) clearly define terms such as "suspicious" and "economically inexpedient."

Exercising Due Diligence

Although it is unclear whether the proposed relatively low fines for noncompliance with these regulatory requirements will deter money laundering, Russian banks can prevent these illegal transactions by exercising due diligence.

Again, international experience shows that banks should be suspicious of transactions not supported by normal business practices; customers who refuse to provide complete background information; cash or wire transactions that do not fit the profile of a certain type of business; customers who seem more interested in evading reporting requirements than being made aware of them; and unwarranted transactions such as dispersing deposits at branch banks. Banks should also ask for prior bank references, conduct background investigations of all partners in a joint venture, and corroborate all information provided by applicants. Banks should also coordinate their activities with regulators, law enforcement agencies, and business associations.

Effective Enforcement

For any of these nascent efforts to be successful, the political will must exist to enforce them. A critical element is a judiciary with the necessary independence to enforce the laws without fear of retaliation. The judiciary must be free to protect the individual rights and responsibilities that are the cornerstone of a free market. Western governments and business participants can encourage these types of reform.

Russian lawmakers should benefit from abundant U.S. experience in these areas, and consider the following:

- A balance should be struck between criminal laws and civil/regulatory controls that will appropriately sanction different types of prohibited activity.

- Prohibitions need to be clearly defined. If they are vague or too broad, they may well discourage legitimate business activities without necessarily preventing criminal deeds.

- No criminal statute, no matter how comprehensive, can guarantee the creation of a market economy free from fraud and corruption. Although some crimes will be prevented by enacting laws that aim to eliminate the economic incentives of illegal activity, the laws' effectiveness will ultimately depend upon thorough investigation, prosecution, and enforcement.

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Quotation of the Month: "Criminal Financial Dealings Dramatically Increased in Russia"

Russian Editor Reveals Banks-Mafia Connection

Banking appears to be one of the most dangerous occupations in Russia. Several dozen Russian bankers have been victims of mafia-style killings in recent months. Among them were the heads of Proftekhhbank, Tekhno-Bank, Pragma-Bank, Mosbiznesbank, the Bank for Development of the Wood Industry, Kuzbassprombank, Eurasia-Bank, the chief manager of Incombank's St. Petersburg affiliate, the chief manager of Agroprombank's St. Petersburg affiliate and the chief accountant of the Russian Municipal Bank. The Russian authorities have not solved any of these cases yet.

Scary Dimensions

This crime wave is a derivative of the dramatic increase in criminal financial dealings in Russia. Law enforcement officials report that financial fraud has reached unprecedented proportions. In 1993, Russian law enforcement agencies reported 110,000 criminal offenses in the realm of finance. In 1994, this number grew to 183,000, and in 1995, to 300,000. The amount of money misappropriated from Russia could be as much as $100 billion in the four year period from 1990-1994, according to specialists in this area. No less than 4 trillion rubles (several hundred million dollars) were misappropriated from Russian banks through faked payment documents and false guarantees from foreign banks during 1993-94 alone.

Abandoning the "traditional" forms of white-collar crime, such as extortion or money laundering, organized criminal groups have found finance scams using bogus credit documents to be far more lucrative. The extent of this crime is difficult to comprehend. Consider the following statistics:

- Law enforcement agencies say that nearly one-third of the $11.5 billion in vouchers which have been sold at auction at the Moscow Interbank Currency Exchange have been bought with the "shadow capital" of Russian organized crime.
- Experts believe that by late 1994, Russia's criminal organizations controlled tens of trillions of rubles. Thus, the amount of "shadow capital" in circulation in the country is roughly equal to that of legal government funds.
- According to information available to the Main Economic Crime Department, in the capital, every year sums totaling as much as the entire city budget—between two and three trillion rubles—simply "vanish." In 1993 alone, law enforcement agencies brought several hundred criminal cases involving attempted or actual thefts of more than 700 billion rubles through banks.
- Counterfeiting of both foreign currency and domestic securities has also increased dramatically. More than 19 million rubles worth of fake vouchers were discovered and removed from circulation during 1993, while in 1994 some 40,000 fake securities and 1.8 billion in counterfeit rubles, produced mainly in Chechnya and Azerbaijan, were confiscated. In Moscow alone some 300 incidents of counterfeiting were reported during 1994, 20 percent more than in 1993. It is estimated that the number of illegal foreign currency operations has tripled since 1993.

The Tale of Several Scams

The scheme typically used to swindle large sums of money is the following: the criminals choose a commercial bank and submit fake payment documents for which they receive funds. These funds are quickly transferred to the accounts of bogus companies, and from there they are scattered among foreign bank accounts. The fraudulent letters of credit used in Moscow originated from more than 20 cities of Russia—many of them from Chechnya and Dagestan. The rubles received when these letters are presented are quickly converted into dollars and sent to Israel, Hungary, Great Britain, France and Monaco.

Another common scheme is the diversion of credits (using fabricated documents) and deliberate non-repayment of loans. A firm obtains credit from a commercial bank, securing the loan with a letter of guarantee from another bank. The borrowed funds pass through the accounts of several bogus companies and are eventually converted into foreign currency with the help of a sham contract with a Western company. The contract is later annulled "by mutual agreement of the parties." The foreign currency is transferred abroad to a firm's bank account.

The following examples of typical scams were provided by police officers:

- Using a fake letter of credit (validated in the name of the CBR Moscow Division's Cash & Payment Center), 4 billion rubles were withdrawn from the account of the Cash & Payment Center and transferred to the accounts of some firms in a number of Moscow commercial banks.
Huge amounts of money (the police have managed to trace only 3.8 billion rubles) were channeled to the accounts of a bogus Moscow company with the help of forged letters of credit carrying the insignia of banks in Azerbaijan and Georgia. The money was transferred to another firm's account in one of Moscow's commercial banks. Some of it was later converted into foreign currency; some amounts were invested in real estate or was invested into the ownership capital of other banks.

The management and the teller of the Tomsk division of Sberbank were arrested for stealing approximately 520 million rubles during a period of eight months. The theft was accomplished by using fake documents.

The managers of the "AVA" and "Retro-Service" firms organized (using several forged letters of credit) a transfer of 3.5 billion rubles to two accounts in the Khimki and Ramenskoe affiliates of Unikombank. Then the money was "scattered" among the accounts of 200 commercial structures, including 113 million rubles sent to the accounts of the Charity Initiative Fund of the Moscow Red Cross Regional Committee. (The "AVA" firm was founder of this fund).

Four forged letters of credit originating in Chechnya were used to steal 3.2 billion rubles. The money was transferred to the "Zhilemstrooi" firm's account in the Moscow branch of Severny bank. As soon as the money arrived at "Zhilemstrooi" it was immediately transferred to the accounts of other businesses, while the general director of "Zhilemstrooi" went into hiding.

One reason why criminals can act on such a large scale, and virtually with impunity, is the flawed system of inter-bank payments introduced by the Central Bank of Russia in 1991. Moreover, to this day the system of verifying banking documents, and more importantly letters of credit, is rather primitive. Corruption is another factor that makes it easy for large-scale financial fraud. Cynical law enforcement officials are prone to believe that the leniency in the banking security system is no accident, since some high-ranking state officials have been known to benefit from the financial scams.

Gang Banks

The crime groups which commit this fraud run well-organized, sophisticated operations. In late 1994 police made arrests in the case of an organized criminal group which specialized in financial schemes in Moscow, St. Petersburg and Orenburg. Its organizers were thirty to forty year old ethnic Chechens and Ingush. The group had its own security squad, a powerful computer center equipped with the latest software and an extensive network of agents in the divisions of the Central Bank, which provided the group with banking forms and stamps and were responsible for organizing the acceptance of fake documents and the transfer of the money received with these documents. According to the police department which uncovered the criminals, more than 40 billion rubles in damage was prevented.

According to police experts, managers of commercial banks are often involved in the schemes. It is believed that the commercial banks receive up to 30 percent of the sums stolen with forged letters of credit. Criminal groups are using increasingly sophisticated methods to penetrate and ultimately control banks. For example they become shareholders and seek to acquire a controlling share of stock. According to some estimates, a quarter of the banks in Moscow linked to organized crime are under the control of ethnic Chechens. Interior Ministry experts argue that 95 percent of Moscow banks and their affiliates are controlled by the criminal kingpins.

Aleksandr Zhilin is Editor for the Moscow Newspaper Moskovskie Novosti. The original article appeared in Prism, a regular publication of the Jamestown Foundation, a non-profit, educational organization. Information: The Jamestown Foundation, 1528 18th Street NW, Washington, DC 20036, fax (202) 483-8337, (E-mail: Long@jamestown.org).

Social Sensitivity

From the Hungarian Economy.
Old Myths about Poland's Reforms Die Hard
by Jeffrey Sachs

Professors Kabaj and Kawalik ("Who Is Responsible for Post-communist Successes in Eastern Europe?" Transition, July-August 1995) repeat every hoary myth about Poland's transformation, not recognizing that the widespread myths of the early 1990s have long been debunked. Despite their moans about "shock therapy," Poland has been the fastest-growing country in Eastern Europe and the former Soviet Union.

As the Financial Times reported (9/29/95), "Poland's booming shipyards, copper mines and re-vamped factories are turning out a flood of new or updated products for export markets and sucking in capital imports for future growth at a similarly fast pace. Export-led growth by Central Europe's biggest economy is demonstrating both the value of earlier structural reforms and the crucial importance of freer trade to the economic rehabilitation of post-communist economies in general.... Official estimates point to a 6.5 percent rise in Poland's gross domestic product in 1995 after a 5 percent growth in 1994." These rates could well be underestimated. When various unrecorded transactions are taken into account, notes the Financial Times, Poland's export-led economy could well be growing at around 8 percent.

Every attempt at "gradual" reform in the region has been vastly more costly in falling living standards than any costs that were incurred in Poland. And Poland's success has come despite the fact that the country, with hyperinflation and plummeting output, was regarded as the worst basket case of the region in 1989—a stark contrast to heavy early favorites like gradualist Hungary.

No matter how many times the claim is made, the "shock therapy" reforms did not cause a "deep decline in food consumption," nor certainly in durable goods consumption. Nor did "unduly cruel reforms" cause the return of the left-wing parties.

Consider the change in per capita food consumption between 1989 and 1993, during the period of the Solidarity-led governments (see table):

<table>
<thead>
<tr>
<th>Item</th>
<th>Employees</th>
<th>Farmers</th>
<th>Retirees</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bread</td>
<td>7.4</td>
<td>5.0</td>
<td>5.9</td>
</tr>
<tr>
<td>Vegetable</td>
<td>5.7</td>
<td>4.5</td>
<td>6.6</td>
</tr>
<tr>
<td>Fruit</td>
<td>35.0</td>
<td>22.8</td>
<td>35.7</td>
</tr>
<tr>
<td>Meat</td>
<td>-2.0</td>
<td>-4.1</td>
<td>10.0</td>
</tr>
<tr>
<td>Fish</td>
<td>-2.2</td>
<td>13.9</td>
<td>1.7</td>
</tr>
<tr>
<td>Butter</td>
<td>-42.5</td>
<td>-33.3</td>
<td>-37.9</td>
</tr>
<tr>
<td>Milk</td>
<td>-21.5</td>
<td>9.4</td>
<td>-16.9</td>
</tr>
</tbody>
</table>


I separate various categories of households to strengthen the point. Household consumption of bread and vegetables rises for every category, and fruit consumption rises very sharply. Retirees enjoy a significant increase in meat consumption and a slight increase in fish consumption as well. Only consumption of milk products declines consistently. Part of this measured decline in "consumption" certainly reflects the enormous improvement in milk quality (including the rapid spread of pasteurized milk in consumption) and the consequent remarkable drop in milk spoilage and wastage. Another part may reflect a shift to a lower-fat diet now that many more choices of high-protein fruits, vegetables, and grains are available.

In the other categories as well, these measures do not reflect the sharp rise in the quality of food sold in Poland's shops. Domestic food processing is one of the enormous success stories of Poland's reforms.

It appears, from preliminary data, that there may have been a decline in some categories of per capita food consumption during 1994 compared with 1993. This may be the result of Poland's severe drought and heat conditions in 1994; of the protectionist food import policies introduced by the Leftist-Agrarian coalition in 1994, which raised food prices and reduced food imports; or of some combination of these and other factors. It is hard to attribute the decline to price liberalization in 1990, or to the macroeconomic policies of the Solidarity-led governments. After all, real GDP growth was an estimated 5 percent in 1994, the highest in all of Europe. Fortunately, the 1995 weather and projected harvest are much improved.

Of course, the positive results of Poland's reforms after 1989 are dramatic in the case of consumer durables, for which the term "economic boom" accurately applies. And again, the gains in ownership are across all types of households. Ownership of VCRs, stereo tape recorders, color televisions, cameras, automobiles, washing machines, freezers, and many other big-ticket items soared between 1989 and 1993, during the alleged social catastrophe that the two professors bemoan.

It is not surprising that various non-economic measures of Poland's well-being support the findings on consump-

Volume 6, Number 11-12
tion. Most important, Poland's life expectancy has risen since 1989, ending a long period of declining life expectancy for males during the 1980s. Again, Poland's post-1989 record on life expectancy, together with that of the Czech Republic (the other radical reform country) is the best in the region, as shown in the following table.

Change in Life Expectancy, Selected Countries, 1970-78 and 1989-93

<table>
<thead>
<tr>
<th></th>
<th></th>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Poland</td>
<td>-0.1</td>
<td>1.0</td>
<td>2.3</td>
<td>0.7</td>
</tr>
<tr>
<td>Czech Rep.</td>
<td>3.0a</td>
<td>0.6a</td>
<td>3.3</td>
<td>0.9a</td>
</tr>
<tr>
<td>Hungary</td>
<td>-1.3</td>
<td>-1.4</td>
<td>2.3</td>
<td>0.0</td>
</tr>
<tr>
<td>Romania</td>
<td>1.3</td>
<td>-0.8</td>
<td>3.3</td>
<td>0.7</td>
</tr>
<tr>
<td>Russia</td>
<td>1.6</td>
<td>-8.3</td>
<td>1.3</td>
<td>-2.4</td>
</tr>
</tbody>
</table>


Unfortunately, in many other countries, particularly in the former Soviet Union—which failed to carry out a decisive stabilization program—the downward course of life expectancy is horrific.

Like many other observers, Professors Kabaj and Kowalik simply fail to differentiate between Poland's continuing low levels of income—the legacy of forty years of communism and the atrocious macroeconomic policies at the end of the 1980s—and the effects of the post-1989 economic reforms per se. The reforms did not cause a collapse of living standards, though the hardships in Poland are all too real. And while the professors castigate me personally for championing radical economic reforms, they fail to note that I campaigned vigorously throughout the world, and successfully, for deep debt relief for Poland, to help overcome the formidable costs of communism that will remain for many years to come.

Ironically, the articles immediately preceding that of Professors Kabaj and Kowalik in the same July-August issue of Transition, one by World Bank staff and one by Oxford Analytica, make clear that the pension costs in Eastern Europe are out of control, and that the pension systems are highly politicized and abused (for example, the disability pensions in Poland, which cover an inordinate proportion of the population). This is the point that I was making in my original article. It is high time for serious reform of the inordinate fiscal costs of social welfare spending—partly to spur growth, partly to reduce the flow of workers and enterprises into the tax-evading black economy, and partly to husband resources for vulnerable groups truly in need.

The author is Professor of International Trade at Harvard University, and has been advising governments in several countries including Bolivia, Estonia, Mongolia, Poland, and Russia.
The Hidden Character of East European Capitalism: Recombinant Ownership
by David Stark

The central question of contemporary debates in Eastern Europe and countries of the FSU is by what means can private property become the typical form of property relations in economies overwhelmingly dominated by state ownership of productive assets? Much of that debate can be organized around two fundamental policy strategies:

- **Transfer assets from public to private hands.** Despite differences in the specific methods used for such privatization (such as sale versus free distribution), the common assumption is that the basic organizational units of the emergent market economy will be the pre-existing but newly privatized enterprises.

- **Develop a class of private proprietors.** The assumption is that this is a slower, but more reliable road to institutionalizing private property. Public policy should lower barriers to entry for small and medium-size private ventures and recognize the existing second economy entrepreneurs as the basic organizational building block of an emergent market economy.

In Hungary property has been transformed in a major way, without the country fitting into either strategy. From late 1988 to mid-1994, the number of state enterprises declined by about 60 percent; the number of incorporated shareholding companies increased more than twentyfold (from 116 to 2,679); and the number of limited liability companies increased from 450 units to more than 79,000. But some firms exist only in the courts' registries, having never produced any income. A great number of "dummy firms" were set up so that expenses (rent, telephone, apartment heating) could be charged to them. Many entrepreneurs still engage in private ventures only as a second job; tax evasion is pervasive; and although employment is slowly increasing in the private sector, the proportion of unregistered work—for which the state receives no social security payments and the employee receives no benefits—seems to increase faster. Some researchers label this transition as one "from second economy to informal economy."

Private entrepreneurs complain of the government's burdensome taxation, lack of credits, negligible programs to encourage regional or local development, and inordinate delays in payments for orders delivered to public sector firms. The private sector responds accordingly: violations of tax codes, off-the-books payments to workers, and reluctance to engage in capital investment are rampant. Such government policies and private sector responses are clearly not a recipe for the development of a legitimate private sector as a dynamic engine of economic growth.

As to the public sector, managers in large public enterprises have modified and transformed property relations; as a result, "recombinant" property has emerged, a form of ownership that cannot be considered either as private ownership with clearly defined property rights, or as a continuation or reproduction of the old forms of state ownership.

**You Hold My Assets, I'm Holding Yours**

The Privatization and State Holding Company (APVRs) and various institutions of local government—which typically had exchanged their real estate holdings for enterprise shares—have majorities stakes in most formerly state-owned enterprises that transformed to shareholding companies. But central and local government agencies are rarely the sole shareholders of corporatized firms. The typical owners of large shareholding companies are other large shareholding companies, as confirmed by a 1993 analysis of the ownership structure in Hungary's 195 largest enterprises and twenty-five largest banks (the latter representing virtually the entire financial sector). Identifying the top twenty owners of each enterprise and bank allowed an accounting of more than 90 percent of the shares held in virtually every company. (These companies employ an estimated 21 percent of the workforce and account for 37 percent of total net annual sales and 42 percent of annual export revenues.)

Some form of state ownership is present in the overwhelming majority of these 220 companies ("companies" here refers to both enterprises and banks). In thirty-six companies foreign investors hold the majority of shares. Hungarian individuals hold 25 percent or more of the shares in twelve companies. In eighty-seven companies at least one major shareholder is another Hungarian company. In forty-two companies other Hungarian companies hold a majority stake (50 percent + 1 share). Thus, almost 20 percent of the 220 companies are unambiguous cases of interenterprise ownership, while in almost 40 percent of these large companies some degree of interenterprise ownership is evident.

**Galaxy of Corporate Satellites**

Under the pressure of enormous debt, declining sales, and threats of bank-
ruptcy or, in the case of more prosperous enterprises, to forestall takeovers and to increase autonomy from state ministries, directors of many large public enterprises were taking advantage of the law that allowed state enterprises to establish joint-stock companies (Rt) and limited liability companies (Kft). In typical cases the managers of these enterprises were breaking up the organization (along divisional, factory, departmental, or even workshop lines) into numerous corporations.

It is not uncommon to find virtually all activities of a large public enterprise distributed among fifteen to twenty such satellites orbiting around the corporate headquarters. As newly incorporated entities with legal identities, these new units are nominally independent—registered separately, with their own directors and separate balance sheets. But on closer inspection, in practice their status is semiautonomous. An examination of the computerized records of the Budapest Court of Registry indicates, for example, that the controlling shares of these corporate satellites are typically held by the public enterprises themselves.

These corporate satellites are, thus, far from unambiguously "private" ventures; yet neither are they unmistakably "statist" residues of the socialist past. Property shares in most corporate satellites are not limited to the founding enterprise. Top and mid-level managers, professionals, and other staff can be found on the lists of founding partners and current owners. Such private persons rarely acquire complete ownership of the corporate satellite, preferring to use their insider knowledge to exploit the ambiguities of institutional co-ownership. Often these individuals are joined in mixed ownership by other joint-stock companies and limited liability companies—sometimes by independent companies, often by other limited companies in a similar orbit around the same enterprise, and frequently by shareholding companies or limited companies spinning around some other enterprise with lines of purchase or supply to the corporate unit. Banks also participate in this form of recombinant property.

In many cases the establishment of new corporate forms is triggered by enterprise debt. In the reorganization of the insolvent firms, the commercial banks (whose shares as joint-stock companies are still predominantly state-owned) become shareholders of the corporate satellites by exchanging debt for equity. The complex, intertwined character of property relations in Hungary means that horizontal ties of cross-ownership are intertwined with vertical ties of nested holdings: limited liability company owned by private persons, by private ventures, and by other limited liability companies, in turn owned by joint-stock companies, by banks, and by large public enterprises, in turn owned by the state.

**Network Called "Recombinet"**

The limited liability companies that began as corporate spinoffs are sometimes linked through ownership ties to more than one shareholding company and, significantly, often linked to other limited liability companies. This network of direct and indirect ties between recombinant properties, linking entities in a given configuration, can be called "recombinet." The recombinet is not a simple summation of the set of horizontal and vertical ties; rather, the characteristics of "horizontal" and "vertical" should be replaced with such concepts as "extensivity," "density," "tight" or "loose" coupling, "strong" or "weak" ties, structural holes, and the like.

The existence of pervasive interenterprise ownership and the emergence of the recombinet organizational form suggests that the actual (de facto) economic unit of the Hungarian economy is not the individual firm but a network of firms. The real units of entrepreneurship and of restructuring are not the individual personality or the isolated firm but the social networks in which previously unidentified resources are recognized and recombined. Property is already being reorganized along such lines; but such networks are not acknowledged in public policy. As long as the policy of privatization is based on getting the highest price for a set of assets already bundled in a given enterprise, and as long as the policies of restructuring and debt consolidation operate on a strictly firm-by-firm basis, the network properties of the Hungarian economy will be underutilized. Networks will remain shady as long as they remain in the shadows of official policy.

Extend these findings to the East European region: the postsocialist economies cannot be adequately represented in a two-sector, public sector and private sector, model. The old property divide has been so eroded that what once might have been a boundary is now a zone. Perhaps the most ironic legacy of state socialism is that at precisely the time that political and economic actors are trying to free the economy from the grip of state ownership, our thinking about property remains essentially Marxist. Policy advisers are busy looking for the owner, although—as developments throughout the industrial countries show—transforming property rights has more to do with renegotiating relations among a wide set of actors to resolve their claims over different kinds of property rights.

**Reorganization in Central and Eastern Europe** is yielding new property forms that are neither statist nor private; economies in the region are mixed, not because there are state-owned firms and privately owned firms but because the
A typical firm is itself a combination of public and private property relations. In these new property forms the characteristics of private and public are dissolved, interwoven, and recombined. Property in East European capitalism is recombinant property and its analysis suggests the emergence of a distinctively East European capitalism that will differ as much from West European capitalism as do contemporary East Asian variants.

Do these organizational monsters contribute to "creative destruction?" That litmus test is based on a widely held assumption that economic development will be best promoted by "allowing the selection mechanism to work" through bankruptcies of underperforming enterprises. Recombinant property would not receive an unambiguously positive score measured by this standard. These kinds of interenterprise ownership are classic risk-spreading and risk-sharing devices that mitigate differences across firms. By dampening the performance of the stronger and facilitating the survival of the weaker firms in the interenterprise recombinet, they might even impede creative destruction in the conventional sense.

But is a tidal wave of mass bankruptcies the long-term cure for the postsocialist economies? An absolute hardening of firms' budget constraints could destroy enterprises that would otherwise be quite capable of making a high performance adjustment. Wanton destruction is not creative destruction, and recombinant property might save some of these struggling but capable firms through risk-sharing networks that do not require massive state bailouts. Extremely high uncertainties in the postsocialist economies can lead to low levels of investment with negative strategic complementarities (as when firms forgo investments because they expect a sluggish economy based on the lack of investments by others). By mitigating disinclinations to invest, risk-spreading might be one means to break out of otherwise low-level equilibrium traps. Firms in the postsocialist transformation crisis are like mountain climbers assaulting a treacherous face, and the networks of interenterprise ownership are the ropes lashing them together.

**Diversity Is Beautiful**

Economic development in Central and Eastern Europe does require more exit (some, indeed many, firms must perish) and more entry as well. But for destruction to be creative, these deaths must be accompanied by births, not simply of new organizations but of new organizational forms.

Socialism failed not only because it lacked a selection mechanism to eliminate organizations that performed poorly but also because it put all its economic resources into a single organizational form—the state enterprise. Socialism drastically reduced organizational diversity and in so doing prohibited a broad repertoire of organized solutions to problems of collective action. The relative paucity of organizational diversity in Eastern Europe gives added urgency to the question, where do (new) organizational forms come from? There are three types of processes generating new organizational forms in Central and Eastern Europe:

- **Imperfect reproduction.** The existing organization or its former personnel tries to establish a new venture by reproducing a successful form. In most cases the outcome is an imperfectly reproduced organizational mutant. If it survives, a new organizational form takes hold. It can contribute to change only at a slow rate, so its importance is negligible.

- **Diffusion from outside.** Western multinationals are entering Central and Eastern Europe, directly bringing in new managerial practices that have strong indirect demonstration effects. Foreign investment can fit neatly into the existing monopolistic structure inherited from state socialism. Many Western multinationals are all too eager to privatize state-owned enterprises because of the inordinate market share that they command. Cigarette manufacturers, for example, are notorious for paying top price in exchange for state concessions that virtually guarantee monopolistic markets. And automobile manufacturers seek state subsidies, preferential credits, and strict import restrictions to reduce competition.

- **De-institutionalization.** Rules that once maintained boundaries between separate organizations are relaxed and organizational boundaries become blurred, generating new organizational forms. In the Hungarian economy, in a process that began in the early 1980s, previously well defined organizational clusters gradually overlapped; broad economic, legal, and social changes eroded the boundaries between state and private property.

An economy's dynamic efficiency rests on diversity, which hinges on its ability to develop new organizational forms. Without diversity an economy cannot adapt to changes in the environment—or it can adapt only at extraordinary cost. It is not in finding the right mix of public and private, but in finding the right mix of adaptability and accountability, that postsocialist societies face their greatest challenge.

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Reform of China's State-owned Enterprises
A Progress Report of Oxford Analytica

Under its Ninth Five-Year Plan, which begins in January, Beijing has committed itself to concentrating on a core 1,000 state-owned enterprises. The others are to become ship has accepted the need for fundamental state sector reform. China's phenomenal economic growth since 1979 was fuelled initially by agricultural advance and more recently by the development of thriving private and "township and village" enterprise sectors. In contrast, the state sector, because of its sluggish economic performance and heavy indebtedness, is widely perceived as an impediment to development.

China's phenomenal economic growth since 1979 was fuelled initially by agricultural advance and more recently by the development of thriving private and "township and village" enterprise sectors. In contrast, the state sector, because of its sluggish economic performance and heavy indebtedness, is widely perceived as an impediment to development:

• In the first eight months of 1995, SOE industrial output expanded by only 8.3 percent compared with a 13.7 percent increase for all industry. According to estimates, non-SOE, on average, received directed credit.

The World Bank study points out. Drawing on an extensive new data base, the report finds that, despite more than a decade of privatization, state-owned enterprises account for nearly as large a share of developing market economies—11 percent on average—as they did fifteen years ago. (In industrial countries the state sector's share dropped to 7 percent from 9 percent in 1980. Transition economies are now privatizing in much greater volumes than developing economies, but they started out with a much larger stock.)

Comparing state-owned enterprises' financial returns, productivity, and deficits, the report finds that Chile, Mexico, and the Republic of Korea were the more successful reformers among nine developing market economies (also including Egypt, Ghana, India, the Philippines, Senegal, and Turkey). Although comparable data were not available for the transition economies, partial information suggests that the Czech Republic and Poland had good results, and China mixed results, among the transition economies investigated.

Successful reformers in both transition and market economies followed similar strategies: increased competition, liberalized trade, lifted price controls, eased barriers to entry, and, simultaneously, hardened budgets, through reducing or eliminating subsidies to SOEs. Both the Czech Republic and Poland reformed their financial systems, improved regulation and supervision, and ended directed credit. Poland introduced legislation that entrusted banks with initiating bankruptcy at poor-performing firms. This decentralized approach can propel troubled firms to restructure and privatize more rapidly, and push inviable firms into liquidation, early signs indicate.

Reformers (successful and unsuccessful alike) tried to improve the incentive structure by changing the relationship between state enterprise managers and the government. They introduced new oversight bodies and increased managerial autonomy and accountability. Results are mixed. Looking for answers, the report considers contracts between government and state enterprise managers, between government and private managers, and between government and owners of newly privatized monopolies.

Performance contracts between government and state enterprise managers: These contracts were common under central planning and are still widely used in China under the contract responsibility system. Some transition governments have considered introducing a variant of these to improve SOE performance. In the developing countries, performance contracts failed to improve profitability or total factor productivity, and in some cases even produced worsening performance. Managers were able to use their information advantage to negotiate multiple, soft targets; the contracts failed to give management an incentive to improve performance; and governments were not committed to the process and frequently reneged on key promises. Thus, these contracts should be used only if they convey clear reform signals and provide rewards for improved performance, as well as curb government's tendency to renege.

Management contracts between government and private managers: These arrangements were not widely used; however, they proved generally successful in transition economies, such as Poland and Romania. In two-thirds of the cases studied they improved profitability and productivity. They work best when they are competitively bid, when the contractors' fee is linked to firm performance, and when government commitment to the contract is signaled by, for example, providing for contract renewal and arbitration of disputes. They are largely confined to a few sectors—namely, hotels, agriculture, and water. The cost to the government of obtaining the information needed to negotiate, monitor, and enforce a management contract is one reason. Information is more easily available, and contract transaction costs thus lower, in sectors where technology is not changing rapidly and output
required less than a third as much investment as SOEs to achieve equivalent industrial output.

*Although SOEs account for less than 50 percent of gross industrial value output, they mounted up almost two-thirds of the 65.5 billion renminbi ($7.89 billion) official losses made by Chinese firms in the first nine months of 1995. This represented an 18.8 percent increase in state sector losses over the same period last year. SOE profits were also down, by more than 20 percent. Moreover, nonofficial statistics suggest total losses by SOEs may exceed 100 billion renminbi in 1995.

### Problem Child: the State-owned Enterprise

The poor performance of SOEs has hurt economic development in four main ways:

**Direct macroeconomic implications:**

- Channeling of resources into loss-making SOEs for political purposes means inefficient allocation. It constrains the economy's ability to generate balanced growth. Many SOEs still receive privileged access to key resources, especially oil and electricity.

- The use of subsidized credit and government transfers to support SOEs is inflationary. It hampers Beijing's attempts to control inflation and prevent another boom-bust economic scenario.

**State revenues:** China expects its budget deficit in 1995 to be a mere 1.5 percent of GDP. If policy lending by centrally controlled banks—most of which is, effectively, transfers to SOEs—is taken into account, the central government's true financial deficit is 6 percent of GDP, and possibly higher. SOEs thus impede the
The government's ability to fund education, social security, and infrastructure.

Effect on banks/financial sector reform: The government is seeking to convert its four giant specialized banks into commercial operations. These banks, wholly state-owned and under the direct supervision of the State Council, control the bulk of banking assets that are critical to China's financial stability. Their transition is jeopardized by the large amounts of policy loans. Last month, Dai declared that "problem loans"—where repayment is at least one year in arrears—constitute 20 percent of all advances made by the four banks.

Interenterprise debt: Many troubled SOEs are unable to pay their debts to other firms. According to official figures, debt owed among enterprises stood at 400 billion renminbi in the first eight months of 1995. This figure would probably more than double if unpayable bank loans were included.

The Bright Side

SOEs still play a critical role in the economy:
- SOEs account for 46 percent of industrial output, albeit down from 70 percent in 1990. Moreover, they are responsible for around half of all exports and most urban employment and wages.
- SOEs are responsible for most large-scale activities, which are the areas that most interest foreign investors. All Chinese firms with overseas share listings are majority state-owned. Likewise, most joint ventures with foreign investors involve state companies. (The private sector is dominated by small-scale concerns.)
- Although 46 percent of SOEs reported losses at the end of the first half-year, others reported healthy profits. Deposits by enterprises have been rising: 30 percent of the increase in individual savings deposits last year is believed to have come from enterprise deposits in nominee accounts to take advantage of higher interest rates.
- With the right capital investment, many SOEs will be able to compete in a more open market-oriented economy. These companies will remain dominant in key sectors and are set to play a significant role in the economy for many years to come.

Impressive advances have been made in increasing management autonomy and in providing incentive structures for workers:
- Top managers now sign contracts specifying performance targets, and their pay is frequently linked to sales and profits.
- Management turnover has increased to almost 20 percent a year, reflecting the fact that managers can be sacked or demoted for poor performance.
- Uniform wage increases have been abandoned, leaving enterprises free to set relative wages.

As long as subsidized credit continues, however, managers of loss-making firms have only limited incentive to improve performance. Furthermore, in some cases managers effectively collude with workers to use state subsidies to pay bonuses all around, regardless of economic performance.

Of the 1,000 SOEs targeted for special assistance under the Ninth Five-Year Plan, 800 are in the industrial sector. These account for about two-thirds of state industrial assets and more than 70 percent of sales revenue, profits, and tax remittances generated by all SOEs. The implication is that the other 13,000 large and medium-size SOEs and 86,000 small SOEs—which are not considered vital to the economy—will be left to fend for themselves. They will presumably become candidates for bankruptcy, merger, divestiture, and management buyout.

Bankruptcy and Mergers

The hardest task facing the government is the closure of the worst-performing SOEs. A bankruptcy law has been in place since 1986, but has been little used owing to its inadequate nature and to state concern over the social implications of mass closures. A pilot project in eighteen "pioneer" cities is currently under way. Some 474 SOEs have been identified as suitable candidates for bankruptcy or merger. Bankruptcy procedures have begun for 161 of them, but only 58 have actually been declared bankrupt. The bankrupt companies had combined debts of 3.2 billion renminbi ($385 million) and assets of just 1.87 billion.

A much-delayed new draft of the bankruptcy law should be presented to parliament next month. This could improve the situation, as it recognizes a creditor's claims on a defaulter's assets. Current law effectively allows only for the protection of workers. Consequently, many creditors, especially banks, prefer to keep debts "sleeping" rather than obtain only part or none of a liquidation settlement.

An alternative to outright closure is the absorption of ailing SOEs by more profitable ones. The government has indicated that it is prepared to consider special loan terms for companies that merge. For the core 1,000 companies, a more comprehensive program of interest payment exemptions, debt-equity swaps, and debt forgiveness is being considered. In theory, such a program of rationalization could bring considerable efficiency savings. However, these will only be realized if the new owners are given a free hand to close plants and lay off workers.

Keiretsu Yes, Privatization No

Although Beijing has accepted the need for ownership reform in order to en-
courage market-oriented behavior among SOEs, it has repeatedly stated its opposition to privatization. Last month Prime Minister Le Peng ruled out privatization as a way of improving Beijing’s prospects of joining the World Trade Organization. An East European-style mass sell-off of state industry is not considered compatible with the development of a socialist market economy.

Instead of privatization, Beijing has embraced the concept of corporatization. Many surviving large and medium-size enterprises are earmarked for transformation into joint-stock companies with public ownership spread across a variety of state institutions and enterprises. In this way, majority "state" ownership is maintained, even though the central government has little or no direct role in running the company.

Corporatization fits well with Beijing’s vision of a more dynamic state sector that dominates key sectors of the economy. It provides a mechanism for the formation of state sector conglomerates and possibly also the development of cross-ownership in the style of the Japanese keiretsu. However, this strategy can only succeed in raising efficiency if subsidies are progressively withdrawn. Furthermore, conflicts of interest between shareholders and enterprises are likely as the former will frequently include the administrative and regulatory bodies of the former central planning apparatus.

For smaller companies and noncore subsidiaries of larger ones, Beijing is likely to allow management buyouts and divestiture. The decisions on individual cases will be left largely to local authorities, as they control most small SOEs.

Although full privatization is politically unacceptable, partial privatization is taking place. A number of SOEs have been listed on foreign and domestic stock exchanges and others are keen to be listed because of the benefits of injections of nonstate capital. The development of corporatization and the expansion of domestic stock exchanges should create a wealth of opportunities for private investors. Private and foreign participation is likely to be mainly restricted to minority shareholding in the "subsidiaries" of state-owned holding companies.

Hainan Airlines provides a good example of how ownership structures in major industries are likely to develop over the long term. The authorities approved the sale of a 25 percent stake to American Aviation Investment with the proviso that it would help the airline "study" foreign management and technology. The rest of the shareholders are state institutions (56 percent), the government (4 percent), and other individuals (15 percent).

Obstacles to Reform

Apart from ideological reservations, there are some major interlinked obstacles to reform and the reshaping of the state sector:

- **Unemployment.** Fear of high levels of unemployment is the main factor holding back rapid reform. Urban unemployment is officially 4.8 million (2.8 percent of the urban population). However, an estimated 30 million out of 100 million SOE workers are redundant. Official statistics show a 66 percent increase in labor disputes in 1994, mainly caused by labor-shedding. Officials claim to have found new work for 99 percent of the workers laid off in the fifty-four pilot bankruptcies. A promising scheme has been pioneered by Dongfeng Motor Co., China’s third largest automobile company, which in 1995 shed 15 percent of its workforce by offering enhanced pension packages to workers who retire early. (Dongfeng is preparing for an overseas share issue.)

- **Inadequate social security.** In addition to layoffs, the divestiture by SOEs of social functions, such as housing, health care, education, and pensions, will lead to hardship for many previously privileged workers. The expansion of state welfare activities and the development of a social security system have not kept pace with reform, officials admit. The labor ministry is drafting laws on social insurance and labor contracts, and is considering laws on employment promotion, training, and dispute settlement.

- **Regional impact.** It is common for a town or towns, or even regions, to be dependent on a few industries and state firms. For example, Maanshan Iron and Steel, which is listed in Hong Kong and Shanghai, has plans to lay off an unspecified number of its 53,000 workforce, which accounts for 13 percent of the city’s population. However, the firms’ actions are constrained because the city cannot absorb its surplus labor.

Excerpted from recent Asia Pacific Daily Briefs of Oxford Analytica, the Oxford (U.K.)-based research group.

"We’re safe! He’s accepted our privatization offer!..."

From the Hungarian Economy.
The World Bank/PRDTE

Book of the Month

Marie Lavigne: The Economics of Transition: From Socialist Economy to Market Economy
by Martin Schrenk

In a market that is flooded with ad hoc collections of diverse country-focused, issue-specific papers (pieced together by their editors' heroic efforts), this book takes a pointedly different approach by presenting a cross-country, cross-issuem synopsis. Part I develops the concept of "real socialism"—in contrast to "ideal socialism," as an abstract model of perfect internal consistency at par with the textbook version of capitalism. The author presents a synthetic prototype economy that combines features relevant "most of the time" (in fact from the 1960s to the 1980s, when a series of piecemeal reforms was already under way) to "most countries" within this group (just briefly citing country specific features). Part II deals with the legacy of real socialism for the formulation of effective transition strategies and policies.

"In the East economists and politicians alike endorse the fundamentals of neoclassical economic science. Their Western advisers eagerly support this attitude, especially as the standard adjustment and stabilization packages which they recommend are based on the same theoretical assumptions," the author points out. She expects that "the disillusions in the transition process will lead to a more complex approach, closer to the political economy concept." In this context, "knowledge of the past helps understand the inertia of the present." She suggests that inspiration be sought "in new approaches, such as the institutionalist one, and the combination of economics with political science and history."

The Past: Real Socialism

Why did real socialism collapse, and why did this happen at this particular time? Although the efficiency gains of the system were declining continuously since the 1950s and had all but disappeared by the mid 1980s, there was no specific economic reason that triggered the collapse. (One could add that most capitalist countries, whether with mature democratic or astute authoritarian governance, had weathered even more severe crises and longer stagnation periods.) In the author's view the system had the potential to "muddle through" indefinitely. The kiss of death was delivered by the breakdown of the command and control monopoly of the communist parties.

In the Soviet Union, Gorbachev let the lid come off by permitting discussions on the dismal economic performance of earlier periods, and on the stifling party control engulfing the daily life of Soviet citizens. Glasnost encouraged open criticism, public discussions, and publication of alternative points of view. The party rapidly lost control over the unfolding process. At some point the "Brezhnev doctrine"—the Soviet Communist Party's claim to ideological and political leadership over the parties in the other socialist countries—was discounted as no longer legitimate. In turn, the rapid disintegration of the socialist governance in the "brother countries" undermined the Soviet Communist Party's claim to represent the leading force of society. The emergence of the administrative and managerial elites exploiting the opening power vacuum, the rapid disintegration of the traditional economic system, as well as the growth of the parallel economy, were the byproducts of the political disintegration.

The parallel or "shadow" economy, regarded by many analysts as an invaluable breeding ground for entrepreneurship during socialism, is one of the most harmful legacies of socialism, claims the author. She argues that the shadow economy created the institutions, the resources, the mentality, and—most important—the networks that permitted the explosive growth of corruption and crime, once central control by the party-state began to wither away. In agriculture for instance, the parallel economy was able to achieve a disproportional high share only through massive appropriation of inputs from the state and the collective sector.

Present: Transition in the Making

The author links the rapid emergence of new wealth to the symbiotic relationship between the nomenclature and the parallel economy. During the early and mid-1980s, members of the bureaucratic and managerial elites were not yet able to accumulate tangible personal wealth or to engage in inconspicuous consumption. But once these formal and informal barriers were torn down, the already existing networks of informal cooperation within the state sector and across its borders were refocused to serve rapid accumulation of wealth.

Quick mass privatization does not create efficient corporate governance by itself, claims the author, who terms "illusionary" the hope that a capitalist entrepreneurial elite of owners will emerge...
spontaneously. "Spontaneous privatization" is, in her view, irrelevant, for there are not enough new owner/managers who can replace the previous managerial class. But, in some sense, all forms of privatization are bound to end up as "spontaneous privatization," with governance largely resting with the established insiders.

If the transition is viewed as a continuing process of indefinite duration—clearly, this is the author's position—then a transition theory is essential to avoid misplaced analogies related to other cultural models. The author locates such theory squarely in the domain of microeconomics. She lists a number of analytical paradigms that are relevant—such as theories of property rights, transaction costs, industrial organization, incentives, principal/agent relations, decisionmaking in the context of bounded rationality, strategic behavior, and asymmetric access to information. In her view transition economies will for an indefinite period remain mixed economies, displaying a specific inertia of the former system. Therefore, "state desertion" of its shareholder role would be destructive. Instead, governance by the state will have to focus on nudging managers toward an adaptive path to entrepreneurial attitudes. The author advocates the prudent use of "industrial policy," without discussing its function and scope in any detail.

Bottom Line

The first part of this book, with its superb overview of the initial conditions that created countless institutional constraints for the transition process, and the second part, the intricate intersections between different subject areas, are invaluable to analysts that are newcomers to the world of transition. The book's quality belies the modesty of its author, who wants her work to serve merely as a "textbook."

In reading the book, however, one cannot avoid asking whether it delivered on the promise—implied in the sequencing of the two parts—of pointing to relevant prescriptions for the future through analysis of the past. From that perspective, the book is a mixed success. The paradigms it proposes—the political economy for the past, and microeconomic niche theories for the present—do not coincide. For instance, the presentation of the CMEA system of mutual trade in the first part is perhaps the most brilliant summary ever written. However, it is by now history. Similarly, although the causes of the collapse of real socialism will rightly engage a generation of historians, it is not immediately clear whether the author's hypothesis will contribute to finding a feasible transition path. And while the author explicitly advocates a "theory of transition," she does not progress beyond listing some of its ingredients. Perhaps the most fruitful "political economy" hypothesis—though it must still be backed up by evidence—is the symbiosis during the 1980s of the parallel economy and the nomenclatura which in the 1990s merged into a new class of wealth-holders.

Marie Lavigne, The Economics of Transition: From Socialist Economy to Market Economy, New York, NY, St. Martin's Press, 295 p. The author is Professor at the University of Pau, France. Martin Schrenk is Consultant, Transition Economics Division, the World Bank.

Upswing

From the Hungarian Economy.
The "Checklist" Is Correct
by Stanislav Menshikov

The "Checklist for Action in the Russian Economy" (Transition, September-October 1995, page 10) rightly points to a serious bias in the Russian government's current economic policies: macroeconomic policies rely too heavily on monetarism. The "Checklist" is correct in suggesting a more "expansionary economic policy" for Russia, one that "is consistent with overall growth." In an economy where half of the available capital and close to a fifth of total labor are not utilized, reliance on fiscal and monetary restriction is tantamount to using a weight-reduction diet to treat a patient suffering from severe malnutrition. What that patient needs is more, not fewer calories, hydrocarbons, proteins, fats, and vitamins. Today's Russia is like that patient: it needs a compassionate doctor, attentive to the needs of the poor, not a rich man's doctor who becomes dictatorial and impatient when treating the poor.

The "Checklist" also rightly indicates that inflation in Russia is of a "different nature" than inflation in Latin America. At present the Russian economy is suffering not from excess demand due to excess money supply but from falling aggregate demand and the inability of most producers to find a sufficient number of domestic consumers who are able to pay. Thus far in 1995 real disposable income has fallen by 10 percent and real wages by 29 percent. Wages are less than half of what they were in 1991. Half of all consumer goods sold in Russia are bought by a well-to-do elite that constitutes only 20 percent of the total population; in contrast, the lower economic brackets account for 40 percent of the population but buy only 16 percent of economic goods. The middle class—usually the principal consumer in any developed market economy—has been effectively wiped out by fiscal and monetary restriction imposed on top of high inflation.

In such an economy stabilization and economic recovery are impossible unless monetary and fiscal restriction is supplemented by active stimulation of aggregate demand. In such an economy inflation is generated mainly by demand factors. Wage-pushed inflation might have been the case two years ago, but not now. Between June 1994 and June 1995 average wages rose by a factor of 2.4 while wholesale prices increased by a factor of 3.7. Industrial production fell only slightly during that period (but the level is only half what it was in 1991), meaning that unit labor costs rose much slower than prices.

Either way, inflation is neither demand-pushed nor labor-cost-pushed. And thus, the finance restriction that has led to widespread delays in the payment of wages (and pensions) has had little if any constraining effect on inflation. But it did prevent recovery of industrial production, which in the first half of 1995 fell by 5 percent compared with the same period in 1994, and was 4.4 percent lower than in the second half of the year.

Nor did fiscal and monetary restraint help curb inflation; average monthly wholesale price increases reached 13.6 percent for the first half of 1995, up from 11.6 percent for the same period in 1994, and from 9.6 percent, measured for the second half of 1994. The boast of having brought consumer price inflation down to 4.6 percent this August from 18 percent in January impresses only those whose memory is failing; in January 1994 inflation rose to 17.9 percent and fell to 4.6 percent in August 1994—in other words, the 1995 reduction is almost identical to the pattern established the year before.

The principal source of inflation in Russia today is the upsurge in energy and raw materials prices. This is the result of the monopolistic or oligopolistic position of these industries, which are able to export a large part of their output while limiting supply to domestic customers. Via cost-push this inflation has been transmitted to final products due to the numerous barriers to competition that organized crime has erected to restrict the free entry into markets of both consumer and producer goods.

Privatization, which could have promoted competition, was implemented in a way that led to criminalization of the economy and therefore to its further monopolization. Restraints to competition have become a continuous rather than one-time factor in diffusing inflation. The actual degree of monopolization is much higher than suggested by traditionally used indicators.

So I agree with the "Checklist" when it calls for significant changes in Russian economic policy, suggesting, among other things, stimulation of aggregate demand and supply-side measures. Of course, the list is hardly a concrete agenda for action since it was meant to outline a general approach rather than a detailed action plan.

Messrs. Tulin and Nellis do not state point-blank that expansionary economic policies are out of order. If they believe, as I do, that such policies are not incompatible with fiscal and monetary discipline, then why not give that advice to the Russian authorities? This would certainly help change the lopsided mon-
eterist mentality prevailing in the Moscow ministries. If not, chances are that a new, left-centrist government would turn the tables completely against both monetarism and the Fund.

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Helpful Data Utilized under Doubtful Methodology

In his recent publication ("Electricity Consumption and Output Decline—An Update," Transition, vol. 6, no. 9-10, pp. 19-20), Istvan Dobozi presents some additional data on changes in electricity consumption as they compare with official data on GDP decline in some Central and East European countries during 1990-94. Mr. Dobozi further develops arguments he published earlier in collaboration with Gerhard Pohl (Transition, vol. 6, no. 1-2, p. 17) to prove that electricity consumption is a suitable proxy for real output trends in the region. Based on his findings, Mr. Dobozi asserts in particular that the current level of decline in output in the former Soviet Union is, on average, underestimated to a greater degree than is the decline in CEE countries.

Today, everybody would probably agree that all official data on decline in output in the FSU are greatly overestimated. There is some consensus that the cumulative fall in output over the past four years has been about one-third of 1990 GDP—not half, as claimed in government statistics. However, it does not mean that the real level of economic activity can be calculated using the available data on electricity consumption. As Vincent Koen mentioned in his comments (Transition, vol. 6, no. 4), the dynamics of electricity consumption is not a more reliable summary economic indicator than official real GDP measures.

The data presented by Mr. Dobozi should be interpreted without overgeneralization. It is true that for three countries in the region—Bulgaria, Hungary, and Poland—the cumulative change in electricity consumption appears to be close to the cumulative change in GDP. But these observations are an insufficient basis for claiming there is a universal relationship between these two indicators for transition economies. In particular, electricity consumption data are inadequate to confirm a hypothesis on unitary elasticity of decline in output.

Given the wide variety in both economic conditions and economic policies across the transition economies, one might expect, contrary to what Mr. Dobozi suggests, that the countries in the region would show substantial variation in the dynamics of their energy consumption. The methodology proposed by Dobozi-Pohl ignores the crucial policy factors that influence energy consumption, such as the level of domestic energy prices, the progress of enterprise reform, the hardness of budget constraints, and the speed of structural adjustment in both output structure and energy consumption mix. It also ignores the fundamental cross-country differences in energy self-sufficiency: other factors being equal, one might expect that the relationship between output decline and energy consumption would be different in energy-rich countries (Kazakhstan, Russia) than in some Eastern European states that are heavily dependent on energy imports and consider the imposition of energy-saving policies a priority for strengthening national independence and security.

On the whole, that a wider gap was reported between the former Soviet Union’s drop in electricity consumption and its decline in GDP, compared with some other countries in the region, does not necessarily indicate a higher degree of underreporting of economic activity. The level of underreported output in Russia, according to some estimates, is comparable to that in Bulgaria and Romania.

What makes the former Soviet republics different is their better access to energy resources and, probably related to that, the generally slower rate of economic reforms in the FSU—the FSU countries have experienced a much slower increase in relative energy prices, enormous subsidization of personal consumption in the housing sector, and a much less aggressive path toward enterprise reform. Russia, which dominates the regional energy markets, until recently has provided its neighbors with underpriced energy (compared with export prices to the rest of the world). Open borders within the FSU have helped consumers in other former republics to get fuel at low Russian domestic prices via smuggling. Under such circumstances, not surprisingly, incentives for saving energy appeared to be weak in the former Soviet Union. Thus, the degree of underestimation of economic activity in the FSU seems to be less than a direct comparison of electricity consumption data with official GDP numbers would suggest.

Analysis of output contraction during the transition is still an important problem for most countries in the region. However, it seems doubtful that a better understanding of this phenomenon can be reached using simplistic and primarily technical approaches.

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Volume 6, Number 11-12
Milestones of Transition

Romanian officials in 1996 expect 4.5 percent growth in GDP, 4.7 percent growth in industrial production, a 3.5 percent increase in agricultural production, and an 8.8 percent increase in investment. Inflation is forecast at 20 percent. It has been announced that a majority (51 percent) ownership in 554 companies will be offered to international investors for cash, swapping 49 percent of holdings for coupons that Romanians earlier received for free.

Romania's first stock exchange since World War II opened on 20 November in Bucharest. A total of seven companies was quoted at the opening session, with five more due to appear in the near future. Of the seven listed companies, only one is completely in private hands; the Romanian state still holds a 70 percent stake in the other six. Initially, it will operate only once a week. Brokers' commissions are subject to a maximum of 8 percent. In 1996

The Czech Republic in November recorded its third highest monthly current account deficit of the year, according to figures of the Statistics Office released on 27 December. The shortfall in November was 10.6 billion koruny ($398 million), compared with 12 billion koruny ($451 million) in October, the worst showing to date for 1995. For the first eleven months of 1995, the cumulative trade deficit was 86.7 billion koruny ($3.26 billion), more than seven times higher than for the same period last year.

The Czech Republic became the first postcommunist state in Eastern Europe to gain access to the Organization for Economic Cooperation and Development (OECD), when it joined the membership on 27 November. Hungary and Poland are expected to follow in its footsteps in 1996. In January the Czech Republic is to submit an application to join the EU.

The recent annual United Nations Conference on Trade and Development reported in early December that Central and Eastern Europe, including the former Soviet Union—a region with more than 300 million people—took in about $6.5 billion in direct foreign investment in each of the last two years. That is less than the FDI recorded for Singapore alone, with a population of less than three million people.

The National Bank of Hungary (MNB) plans to maintain the current crawling peg devaluation of the forint—1.2 percent per month—during the first half of 1996, and to lower that rate during the second half of the year. The MNB predicts a 1996 current account deficit of less than $2 billion (compared to $3 billion in 1995), GDP growth 1.5 to 2.0 percent higher than the expected 0.5 to 1.5 percent in 1995, investment 9 to 11 percent higher than in 1995, and consumer price inflation of 19 to 21 percent (comparred with about 30 percent in 1995). The Ministry of Industry and Trade predicts a 7 to 10 percent rise in exports and a 4 to 6 percent rise in imports in 1996—a narrowing of the trade deficit, due to productivity growth, economic restructuring, and macroeconomic stabilization. There are 25,000 foreign companies in Hungary, and total foreign investment now stands at around $8 billion. Real wages are expected to fall next year, but the downward trend should end by 1997, with a modest rise in 1998.

On 2 November Latvia fundamentally reformed its pension system, linking benefits to contributions, which are in turn tied to wages. Other provisions include indexing benefits to inflation, allowing workers to choose when to retire (though the pension is lower the younger they retire), a gradual reduction in the rate of social tax on employees (from 37 percent to 33 percent), and an increase in that rate on workers (from 1 percent to 5 percent). A better link between benefits and contributions is expected to increase incentive to refrain from activities yielding undeclared income. Latvia now has perhaps the most modern pension system in the region.
The Latvian Economic Court on 12 December declared Banka Baltija, formerly the largest commercial bank in the Baltic States, officially bankrupt. The activities of the bank were suspended in May 1995. Losses to the bank's 200,000 depositors are estimated at some 200 million lati ($370 million). The government has paid out slightly more than 1 million lati in compensations to 6,214 depositors.

In late December Lithuanian police arrested high officials of the country's two largest commercial banks, Litimpeks Bank and Akcinis Inovacinis Bank (LAIB) on charges of squandering large sums. Both banks have been shut down until further notice, bringing Lithuania's financial sector activity to a halt. Litimpeks squandered 150 million lita ($37.5 million) and LAIB 271 million. Citizens have deposited some 300 million lita ($75 million) in LAIB. The government guaranteed interbank loans of up to 300 million lita to avoid a paralyzing chain reaction. By 20 January the banks should resume operation.

The average monthly income of a Lithuanian family member in the third quarter of 1995 was 265 lita ($66), according to a survey of 1,244 families conducted by the Lithuanian Statistics Department. In real terms income rose by only 5.6 percent, and it actually decreased by 13.8 percent compared with a year ago. Food purchases accounted for 57 percent of all expenses, with housing, heating, and energy costs making up 11 percent. A mere 2.1 percent was spent on health care, compared with 4 percent on alcohol and tobacco.

Russian President Yeltsin issued a presidential decree abolishing as of 1 December, all export duties on refined oil and timber products. From 1 January 1996, export duties on all other products are scrapped, except those on crude oil, gas, and some industrial goods, on which export duties will be halved. The government is responding to the fact that crude oil exports fell 5.1 percent in the first ten months of 1995. The tax on crude oil exports is currently $46 per metric ton. The duty on gas exports was increased in early November from $2.6 to $6.5 per 1,000 cubic meters.

In the first eleven months of 1995, Russia's GDP fell by 4 percent and industrial output by 3 percent compared with the same period in 1994, according to official figures released in mid-December. GDP for 1995 is estimated at 1,650-1,700 trillion rubles ($360-$368 billion). The rate of economic decline slowed in 1995 in comparison with 1994, when Russia's GDP and industrial output were down 15 percent and 21 percent, respectively. Official figures also show a 12 percent decline in real income over the first eleven months of 1995.

In Russia the ruble corridor has been extended for the six months beginning on 1 January, and the ruble will be allowed to float between 4,550 and 5,150 to $1, instead of the present 4,300-4,900 band. That means the ruble will be allowed to devalue by up to 13 percent.

First Deputy Prime Minister Anatoli Chubais and others oppose devaluation because it will tend to increase inflation. (Figures for November show inflation to be holding at 4.5 percent per month.) Exporters want the ruble to fall in order to restore their profitability. Aleksandr Livshits, President Yeltsin's chief economic adviser, in a 22 November interview expressed support for both an easing of conditions for exporters and some relaxation in interest rates.

Agriculture ministry official Alexander Vasyutin said Russia's main grain harvest in 1996 could recover to 77 million-80 million metric tons after the drought damage of 1995. But an Economy Ministry forecast suggests that reserves of domestic grain could be exhausted by June 1996, and that Russia might need to buy up to 6 million metric tons of grain by the summer of 1996.

Russia and the London Club of 600 creditor banks have concluded a framework agreement on the rescheduling of loans and interest totaling $32.5 billion. In a mid-November meeting in Frankfurt it was decided that Russia will be granted a seven-year grace period, during which it will only pay interest. The agreement does not formally forgive any of Russia's debt, as did a similar agreement with Poland, but it spreads out the repayments over twenty-five years. Over the past four years the banks rolled the loans forward every ninety days. On 15 November the Paris Club of official creditors had also agreed to reschedule the $40 billion it is owed by Russia, although a timetable was not agreed upon.

The number of Russian banks registered as of 1 October 1995—2,570 commercial banks and 5,760 bank branches—is still relatively scant, in relation to the size of the economy, and many banks are quite small, according to Sergei Dubinin, the new head of the Central Bank. According to a survey conducted by the Public Advisory Committee on Banking Legislation of the Federation Council, 40 percent of the commercial banks were founded with a capital base of less than 500 million rubles ($110,000). In the first nine months of 1995, 114 commercial banks had their licenses revoked for violating financial legislation.

Russia reduced energy supplies to CIS member countries in 1995. For the period January-November 1995, Russian deliveries of gas, crude oil, and petroleum products were down in volume by 9 percent, 19.5 percent, and 57 percent, respectively, compared with the same period in 1994, despite a higher unit
price. The value of Russia's overall exports to CIS countries for this period declined by 3.5 percent to $12.4 billion against the same period last year. Imports totaled $11.5 billion, up by a spectacular 24.2 percent against the same period in 1994, mainly on account of foodstuffs imported by Russia from CIS countries. Overall Russian exports during the first eleven months of the year rose 21 percent and the trade surplus widened to $31 billion.

Russian oil and gas production in 1995 is projected at 296 million tons of crude oil and 551 billion cubic meters of gas, a 4 to 5 percent drop compared with the corresponding figures for last year (308 million tons and 581 billion cubic meters, respectively), according to the government's Economic Situation Center.

Ukraine will step up structural reforms and bring down rising inflation to a monthly average of 1 percent in 1996, President Leonid Kuchma said. National Bank Chairman Viktor Yushchenko said that sluggish privatization is a major reason the budget deficit exceeded the IMF-supported target of 7.2 percent of GDP in 1995. Only 2 trillion ($11 billion) of the 92 trillion karbovantsi ($526 million) expected from privatization in the first nine months of 1995 has been collected. The government has been forced to underfinance government activities rather than print money to avoid further jumps in inflation. As a result, hundreds of thousands of Ukrainian coal miners, teachers, physicians, and academics have not been paid since the spring 1995.

In Slovakia, which, according to the Financial Times, is the second fastest growing economy in Eastern Europe, the current account for the first eleven months of 1995 remained in surplus, at 3.3 billion koruny ($111.5 million). The 1996 budget plans on revenues of 162.4 billion koruny ($5.6 billion) and expenditures of 189.4 billion koruny, GDP growth of 5 to 6 percent, and inflation of 6 to 7 percent.

Cuba's economic plan for 1996 aims to increase the pace of economic recovery through a rebound in sugar production and higher revenues from the growing tourist industry. José Luis Rodriguez, economy minister, forecast GDP growth of 5 percent in 1996, double the 2.5 percent announced for 1995 (compared with an overall 35 percent decline from 1989 to 1993). Exports should increase by 20 percent and imports by 15 percent. In the first detailed statistical report on its economy in five years, Cuba has used IMF guidelines to compile previously unpublished balance of payments figures. The report puts the total foreign debt at $9.1 billion at the end of 1994.

Poland's GDP is expected to grow 5.5 percent in 1995 and 6.5 percent in 1996, Finance Minister Grzegorz Kolodko announced. In 1996, imports are projected to grow 13.6 percent and exports 16 percent, while investment will increase by 8.5 percent. Real wages will grow 3.5 percent (5.5 percent in the public sector). The unemployment rate remained steady at 14.7 percent in November. While Kolodko forecasts consumer price inflation for 1996 at 17 percent, down from 22.7 percent in 1995, the national bank projects 19 to 21 percent. To stem inflation, the central bank recently revalued the zloty by 6.4 percent from 2.7 to 2.53 zlotys per dollar. By early November, foreign reserves reached $13.5 billion, up from $6 billion at the start of the year.

Nine hundred fourteen state enterprises (27 percent of the total) in Poland were transformed into joint-stock companies owned by the state treasury between July 1990 and October 1995, according to the Polish Privatization Ministry. The process will get a boost as coupons are distributed under the new mass privatization program launched on 22 November. Up to 28 million adults should become shareholders, and new management should be brought to more than 500 firms. Each citizen is allowed to have one coupon, costing 20 zlotys ($8) apiece. After twelve months, the coupon holders—if they do not sell their coupons on the free market—can exchange their certificates into fifteen shares, one for each of the fifteen national investment funds, which will be traded on the Warsaw Stock Exchange. (The fifteen funds, which control the 500 firms, are worth a total of about $3.1 billion.) Analysts say that up to 30 percent of the firms participating in the program, mostly medium-size firms, are in a difficult financial situation.

Latest Polish statistics put the number of people currently working in the underground economy at least two million, with 43 percent not paying taxes and another 57 percent holding second jobs with untaxed earnings.

Bulgarian National Bank governor Todor Valchev on 15 December suggested that the projected 1996 budget deficit of 4.5 to 6.0 percent of GDP will hurt health, education, and the legal system. (A deficit of 7 percent GDP equivalent is expected in 1995). For 1996 the government projects 20 to 25 percent inflation (35 to 40 percent in 1995); an exchange rate of 80 to 83 leva to the dollar (currently 69.4 leva), a budget deficit of 4.5 to 6.0 percent of GDP, 2.5 percent growth of GDP (about the same as 1995), and a 25 percent annual interest rate (4 percent at end 1995). The projection calls for reintroducing administrative control over wages at state enterprises for the first time since 1990. Bulgaria's foreign reserves stand at $1.4 billion while debt payments in 1996 will be $1.25 billion.

The United Nations 1995 Human Development Report—which measures...
GDP, real spending power, life expectancy, and education level—put Bulgaria in 65th place among the 174 UN members. In 1991 Bulgaria ranked 33rd and in 1994 it was 48th. According to the report, average life expectancy went down by almost four years since 1991, and is now 71.2 years. Men’s life expectancy is only 67.6 years, and women’s 74.4. Some 7 percent of the Bulgarian population are "absolutely illiterate." A ranking of women’s emancipation, which includes women’s participation in economic and political decisionmaking, puts Bulgaria in 20th place, two below Hungary. Bulgaria and Hungary are the only former Communist countries among the top 20.

China’s adjusted GDP is seen growing 9.7 percent in 1995, according to China Securities, citing State Information Center data. Figures released by the State Economic and Trade Commission predict a gradual cooling of China’s overheated economy in 1996, with 9 percent GDP growth, compared with 11.8 percent in 1994 and 9.8 percent in the first nine months of 1995. The retail price index is forecast to rise by 15.5 percent in 1996, almost the same rate as measured for the first eleven months of 1995 on a year-on-year basis (15.4 percent). Retail prices are expected to rise an annual 14 percent in 1997.

Inflation in Albania was 0.7 percent for October. Since the national bank expects inflation to run at between 1 percent and 1.2 percent during November and December, the goal of 10 percent annual inflation in 1995 appears attainable. The budget deficit target, 7 percent of GDP, is also within reach. These figures continue the improving trend that began in 1992, when inflation was in the triple digits and the budget deficit was a double-digit share of GDP.

In Tirana a stock market will open in March 1996, and will trade shares in Albania’s recently privatized companies. The government is preparing to set up a register of shares. In the first round of privatization, twenty large and medium-size state-owned enterprises were privatized through the sale of vouchers. Of the 4,000 shareholders in Albania, 2,700 are employees of the privatized companies, mainly in public services, trade, construction, and agriculture. The second round of privatization will include industrial enterprises. A total of 350 companies will become private by the end of 1996. Meanwhile, 4.4 billion lek ($48 million) in privatization bonds have been provided to people persecuted for political reasons under communism.

According to the International Labour Organization, restrictive income policies in Central and Eastern Europe, have not resulted in economic recovery and can lead to serious social tensions. After the fall of communist regimes in the region, most countries slashed real wages to curb inflation and rein in soaring budget and current account deficits. "If real wages further decline ... we see some serious economic and social risks," says Werner Sengerberger, director of the ILO’s Central and East Europe Team. The restrictive policies have not only aggravated social and political problems in the region; they have also proved economically inviable as consumption fell along with living standards, according to ILO counselor Daniel Vaughan Whitehead. The ILO suggested that the region’s governments should try to improve productivity instead of restraining wages.

The government of Kazakhstan has accepted an economic reform plan extending through 1998 and a draft budget for 1996. In a 28 November session, Kazakhstan Prime Minister Akezhan Kazhegeldin pledged to continue macroeconomic stabilization and economic restructuring. The program aims to bring inflation below 12 percent in 1998, a significant drop from the 42.4 percent it ran in the first ten months of 1995. It is hoped that next year's inflation rate will be 26 to 28 percent, while the value of the tenge will drop from 63.3 to $1 down to 71 to $1. GDP in 1996 should reach 1.31 trillion tenge at the latter rate. Kazakhstan's cabinet has approved a draft 1996 budget that plans a deficit of 3.3 percent of GDP, a halving of inflation, and stability for the national currency.

Slovenia becomes a member of the Central European Free Trade Agreement (CEFTA) in January 1996, joining the Czech Republic, Hungary, Poland, and Slovakia. Slovenia’s Minister of Economic Relations and Development Janko Dezelak expects a substantial increase in trade with CEFTA members.
World Bank/IMF Agenda

IMF Standby to Romania

The IMF has approved an extension of Romania's current standby credit through April 1997, and has augmented the amount available by $280 million. The extension of the IMF program was requested by the government to help continue external support for macroeconomic and structural adjustment measures, the IMF said. Economic performance in Romania during 1994 was marked by a sharp improvement in confidence, but developments in the first nine months of 1995 presented a more contradictory picture, as further acceleration in growth was accompanied by the reemergence of balance of payments pressures. The 1996 program aims to achieve 4 percent growth, bring down inflation to less than 20 percent, and reduce the current account deficit to 3.4 percent of GDP.

World Bank Loan to Latvia

Latvia can accelerate its municipal service development, under a $27.3 million World Bank loan approved on 14 December. The loan will help rehabilitate the transport system in Riga and the water and wastewater treatment plants in Daugavpils, and will set up a pilot municipal development fund to channel long-term credit for small-scale investments in other municipalities.

Russia Draws IMF Standby Tranche

The IMF has agreed to disburse the eighth tranche of its standby credit to Russia, a payment worth about $550 million. The IMF's $6.25 billion standby loan to Russia, approved in March, was suspended following the military intervention in Chechnya. In April the IMF agreed to resume payments in monthly installments. Four more tranches remain of the standby credit, whose term expires in February 1996. Thomas Wolf, head of the IMF mission in Moscow, announced that an agreement on the three-year extended financing program probably would be signed in January 1996.

Personnel Changes in the World Bank

Effective 1 January 1996, Johannes Linn replaces the retired Wilfried Thalwitz as Vice President, responsible for the Europe and Central Asia Region. Mr. Linn, a German national, joined the Bank through the Young Professionals Program in 1973. After serving in various positions in the Bank, in 1991 he was appointed to Vice President, responsible for financial policy and risk management. Also effective 1 January 1996, Kemal Dervis is promoted to Vice President, Middle East and North Africa Region. He will continue to oversee the Bank's operations in Bosnia. Mr. Dervis, a Turkish national who joined the Bank in 1977 as Economist, served as Director of EMENA (later Europe and Central Asia Regional Office), Country Department II, since 1987.

Donors Pledge $2.3 Billion to Viet Nam

Donors at their Paris meeting in early December pledged to give Viet Nam $2.3 billion in aid. World Bank Director Callisto Madavo, Chairman of a consultative group meeting, reported that $1.8 billion will be project aid, $360 million program aid, and $130 million technical assistance. Viet Nam is aiming for 8 to 10 percent economic growth and 14 percent inflation in 1996, and a World Bank report has advised that deeper and faster reforms are needed if such growth is to be achieved. (At last year's donors group meeting, $2 billion was pledged for Viet Nam in 1995.)

IDA Credit to Viet Nam's Banks...

An IDA credit of $49 million will strengthen the commercial banking sector in Viet Nam through new national and commercial interbank payment clearing and settlement systems. The credit will finance both technical assistance and equipment. Besides the State Bank of Vietnam, six other commercial banks, accounting for 90 percent of Viet Nam's banking sector, will take part in the project.

...to Armenia's Infrastructure

An IDA credit of $12 million to Armenia will finance small-scale infrastructure projects in the poorest areas of the country, and will assist the local implementing agency, the Armenian Social Investment Fund. Microprojects in infrastructure will include the rehabilitation of clinics, primary schools, and feeder roads, as well as improvements in sanitation and water supply. Overall goals are to improve living conditions, strengthen small local contractors, generate employment through public works,
and enable policymakers to better analyze trends and conditions.

...and to Albania's Agrobusiness

An IDA credit of $6 million to Albania, approved on 12 December, will help to develop and restructure the country's agroprocessing sector, so as to improve the marketing of farm products. The credit also provides for the training of farmers and for assistance to entrepreneurs and professional associations.

Nicaragua Buys Back Debt Cheap

Nicaragua has bought back $1.1 billion of its commercial bank debt at a price of 8 cents to the dollar. The total value of the transaction, including canceled interest claims, is $1.4 billion. The buyback will eliminate 81 percent of the country's outstanding commercial bank debt. The World Bank's Debt Reduction Facility for IDA-Only Countries backed the operation with a $40 million grant; the Inter-American Development Bank provided a $40 million loan; Holland, Sweden, and Switzerland, offered additional support of $8 million.

New IFC Guidelines

The IFC has adopted a new set of guidelines for operating in emerging market economies. Provisions of the guidelines include increased use of joint mandates with commercial and investment banks to conduct feasibility and other work; a pledge not to bid competitively for privatization business under normal circumstances; use of private advisers to the "fullest extent" possible; and the adoption of strict standards for IFC participation in the underwriting and placement of securities. (Information: Mauricio Perea, IFC, Corporate Relations Unit, Room 1-3133, tel. (202) 473-7997, fax (202) 676-0355.)

IFC Stake in Cetal

The IFC, together with ABN-AMRO Bank, the Czech Zivostenka Banka, the Hungarian Foreign Trade Bank, the Polish Development Bank, and the European Bank for Reconstruction and Development (EBRD), has set up the Central Europe Telecommunications Agency Line (Cetal). Cetal will have $100 million in funding and aims to offer credits and shares to telecommunications firms. The IFC and EBRD will each provide $33 million to Cetal.

GEF Grants to Save the Ozone

The Global Environment Facility (GEF) will provide a total of $23.6 million in grants for environmental projects in three transition countries. The World Bank is one of three implementing agencies of the GEF. Bulgaria, Hungary and Slovenia will receive $10.5 million, $6.9 million, and $6.2 million, respectively, to phase out ozone-depleting substances (ODS) as agreed by the 1985 Vienna Convention and the 1987 Montreal Protocol on ODS. On 21 December the GEF approved a grant of $3.2 million to Russia to help to identify and reduce the emission of greenhouse gases.

Poland Gets Energy Loan

The World Bank has approved a $160 million loan for a power transmission project in Poland. The loan will provide 95 percent of the foreign exchange component of the estimated $276 million total project cost.

China Portfolio: Fighting Pollution...

The World Bank on 19 December approved a loan of $125 million and a credit of $25 million for an urban environmental project in Hubei Province, to support wastewater handling, air pollution control, and solid waste management. The loan will be used to purchase equipment and facilities for wastewater and municipal waste management; to extend credit to large-scale industrial enterprises to carry out pollution abatement works; to fund water quality monitoring and management; and to finance technical assistance and training.

...Developing the Labor Market....

A World Bank loan of $10 million and an IDA credit of $20 million, both approved on December 19, will support a pilot project aimed at attacking chronic underemployment in China's state-owned enterprises. The project will provide legal expertise as well as employment and training services in five cities and the province of Zhejiang. According to some estimates, 15 percent, or 16.8 million, of China's state enterprise workers could be made redundant with little or no impact on production capacity.

...and Controlling Disease

IDA has approved a credit of $100 million to boost disease prevention in ten poor provinces in China. The credit will support training of health workers, implementation control of sexually transmitted diseases, encouragement of community-based interventions, and coordination among provinces, cities, and health agencies.

Solving IDA Funding Crisis

Thirty-two donor countries meeting in Luxembourg and London in mid-December agreed on the outlines of an interim plan for refunding the World Bank's IDA, to begin in July 1996. This interim solution would put together a three-year IDA replenishment of some $14.3 billion (compared with current IDA funding of roughly $20 billion). The plan would exclude the United States for about two years.
Reconstruction in Bosnia

A donors meeting involving fifty countries and twenty-seven international organizations, convened in Brussels and hosted by the World Bank and the European Commission, agreed on 21 December to mobilize a $500 million aid package for war-torn Bosnia and Herzegovina over the first quarter of 1996. The initial infusion is to be followed by a longer-term, $5 billion program—the largest reconstruction effort in Europe since the end of World War II.

Preliminary data collected by the World Bank and other sources paint a bleak picture of Bosnia's present social and economic situation:

- In four years of war, about 250,000 persons were killed, more than 200,000 were wounded, and an estimated 2.3 million were displaced, out of a total prewar population of roughly 4.5 million. (The population is now estimated at 3.4 million.)
- Annual per capita income has plunged to about $500 from $1,900 in 1990.
- Around 45 percent of all industrial plants, including perhaps 75 percent of all oil refineries, have been destroyed, and a much higher percentage has been robbed of machinery and equipment.
- The surviving industry operates at 5 to 6 percent of the level of its prewar capacity.
- Thirty-five percent of roads and 40 percent of bridges are damaged or destroyed.
- Damage to the railway system is estimated at $1 billion.
- Seventy-eight percent of electrical generating capacity is out of commission, and coal production is less than 10 percent of prewar levels.
- The damage to the telecommunications system is estimated at more than 500 million; daytime international telephone call completion rates have dropped to 1 or 2 percent.
- One-third of all health care facilities and half of the country's school buildings have been seriously damaged or destroyed; the infant mortality rate has doubled.
- Seventy percent of the total housing stock is destroyed or damaged.
- Domestic food production satisfied only 35 percent of the country's needs, about 80 percent of Bosnia relies on outside food aid.
- Less than one-quarter of the prewar working population is employed.

At the Brussels Conference, the World Bank—which will serve as coordinator of aid money and economic consultant to Bosnian government—and the European Commission presented a priority program for the first quarter of 1996. The key priorities:

- Service Bosnia's foreign debt. (The total foreign debt amounts to $4.2 billion, the country is more than $1 billion behind in its loan payments to commercial banks, donor nations and international organizations.)
- Reorganize the country's transport, power, gas, and water and waste management sectors, as well as provide financing for agricultural production and for rebuilding the education and health care systems.
- Establish a social fund to help the elderly and other particularly vulnerable groups.
- Jump-start production in small and medium-size enterprises by providing working capital.
- Make available backup reserves to the central bank.
- Strengthen domestic institutions that will play an important role in the recovery program.

The World Bank will make a special allocation of $130 million to Bosnia, in advance of the country's becoming a member of the World Bank Group. Arrears on debts to the World Bank and the IMF that were inherited from the former Yugoslav Federation totaled $489 million. Those arrears had to be cleared up before the country could join the Bretton Woods organizations.

The IMF approved Bosnia and Herzegovina for membership on 21 December and granted the country an emergency $45 million credit (used primarily to repay Holland, which had provided short-term financing to clear Bosnia's arrears of $37 million). The IMF supported a plan whereby the country's new central bank will operate for at least six years as a currency board, issuing currency only with full foreign exchange backing. Furthermore, the government and public sector entities will refrain from financing fiscal expenditures through domestic bank loans.

Once admitted as a World Bank member, Bosnia would likely be eligible to borrow from IDA (the International Development Association). The World Bank will set up a trust fund to administer donors' contributions. The EC would make an exceptional upfront effort for specific rehabilitation projects and critical imports amounting to a contribution of $112 million in the first quarter of 1996.

Longer-term projects, primarily rebuilding infrastructure, transport, water and sewerage, will require around $5 billion over a three-year program period, nearly half of which should be committed by the first year, according to World Bank estimates. The initial proposal allocates $900 million for the restoration of the electricity grid and $600 million for housing. Priorities also include restoration of food production and agricultural distribution, rebuilding schools and hospitals, as well as some smaller investment in industry. Final agreement on financing the reconstruction effort is expected during a major donors' conference, planned for March 1996.

A recent Financial Times editorial pointed out that the task at hand is not only the reconstruction of an economy that has been more than 70 percent destroyed. The challenge is also to build a different kind of economy than was left by Tito to the former Yugoslavia. Even before the war, the country faced hyperinflation and risked defaulting on its foreign debt. Rapid privatization, self-help building projects, and an effective food-aid system are the keys to restarting economic activity, according to the editorial. The Times added that the World Bank has also stressed the need to build the administrative structures necessary to sustain longer term reforms and infrastructure investment.
with the hope that the the U.S. would come aboard again once it has cleared its arrears of $935 million and overcome the antipathy toward foreign aid exhibited by the Republican-dominated Congress. The participants reached a consensus on the urgent need to keep up the flow of IDA credits to the most needy nations, whose ranks have grown with the addition of Bosnia and the Asian countries of the FSU.

IMF Agrees with Hungary on Standby

The IMF and Hungary have set the basis for an agreement over a standby arrangement, pending parliamentary approval of satisfactory 1996 budgets for the country's two social security funds. Parliament is expected to pass the budgets early 1996. Hungary's socialist-led government expects a boost of international confidence once the IMF standby is signed. It does not intend to draw on the credit. (Official reserves were up by $2 billion, reaching $9.2 billion by October 1995, and a further $3 billion in revenue from the latest privatization wave is also expected to flow in.) In fact, in October 1995 Hungary made an advance payment of $620 million it owed to the IMF.

New IMF Credit Package to Uzbekistan....

The IMF approved a $259 million credit package to Uzbekistan on 18 December. The agreement includes $185 million in standby credit and $74 million from the IMF's systemic transformation facility (STF). The funds will be used to help limit negative growth to 1.5 percent in 1996, against 3.5 percent in 1994 and 2.0 percent in 1995, as well as to hold the annual inflation rate to an anticipated target of 21 to 25 percent.

IMF officials expressed their support of the Uzbek government's tight monetary and fiscal policies.

... to Azerbaijan ...

The IMF is offering $127.3 million in support of the Azerbaijan government's 1995-96 economic reform program. Of the total, $84.8 million is being made available under a one-year standby credit, and $42.5 million is being disbursed as Azerbaijan's second drawing under the systemic transformation facility (STF).

... and to Kyrgyzstan

The IMF has increased the amount of loans available to Kyrgyzstan under the three-year economic restructuring program from $105 million to $131 million. The move comes in response to the country's efforts to reduce inflation, stabi-
Conference Diary

For the Record

Real Estate, Construction, and Construction Project Finance in Russia
November 15-16, 1995, New York City, New York, United States

Sponsored by the Geonomics Institute, the conference focused on legal and regulatory reform; providing warehousing and materials transportation services; new construction versus improvement projects; housing markets and construction projects; commercial construction, design-build, and turnkey projects; locating and working with dealers and agents; local production and availability of building materials; safety and environmental standards and specifications; and project financing and financing for import of wholesale machinery and equipment.

Information: Geonomics Institute, 14 Hillcrest Avenue, Middlebury, Vermont 05753, USA, tel. (802) 388-9619, fax (802) 388-9627.

Satellite Communications in Russia and the CIS
November 28-29, 1995, Moscow, Russia

Sponsored by the Adam Smith Institute, the conference discussed current and future trends—analyzing the recent changes in Russia’s space research policy; conversion of military into civil installations; developments in platform launchers, space complexes, and equipment for satellite communications; cooperation with the international business community; and business opportunities in the Russian space industry: designing and operating commercially-oriented space systems.

Information: Dorothea Jilli, The Adam Smith Institute, Conference Division, 11-13 Charterhouse Buildings, London EC1M 7AN, tel. (44 171) 505-1023, fax (44 171) 490-8932.

International Round Table on Privatization in the Economies in Transition
December 8-10, 1995, Knez Mihailova, Belgrade

Sponsored by the European Centre for Peace and Development of the United Nations University for Peace. The purpose of the International Round Table was to examine experiences and results to date, as well as future prospects and directions for privatization in the economies in transition. Round table proceedings will be disseminated to interested government, business, and scientific structures in the economies in transition to help them in their privatization efforts.


Forthcoming

Researching East European Markets—The View from the Region
February 23, 1996, London, United Kingdom

Organized by CIS-Middle Europe Information Service and the London Business School. Topics will include methods of research and sources of information—company data, market sector reports, statistics—in Bulgaria, the Czech Republic, Hungary, Poland, Romania, and Russia.

Information: Wendy Shelley, CISME Information Service, London Business School, Sussex Place, Regent's Park, London NW1 4SA, UK, tel. (44 171) 706-6870, fax (44 171) 402-8979, (E-mail: cisme-info@lbs.london.ac.uk).

European Societies or European Society? Social Exclusion and Social Integration in Europe: Theoretical and Political Perspectives on Poverty
March 26-31, 1996, Blarney, Ireland

Organized by the European Commission/ESF.

Information: Josip Hendekovic, European Science Foundation, 1 quai Lezay-Marnesia, F-67080, Strasbourg Cedex, France, tel. (3388) 767-135, fax (3388) 366-987, (E-mail: euresco.esf.org).

Harvard-Columbia Arden House Conference
March 29-31, 1996, New York, United States

Cosponsored by Harvard University's Russian Research Center and Columbia University's Harriman Institute, the 20th Annual Arden House Conference will be held at the Arden House Conference Center in Harriman, New York. The conference theme this year: The Russian Elections—How Will Growing Nationalism Affect Foreign Investment? As in the past, speakers will be drawn from the academic, government, and business sectors in Russia, Europe, and the United States.

Information: Harvard Russian Research Center, Harvard University, 1737 Cambridge Street, Cambridge, MA, USA, 02138, tel. (617) 495-8900, fax (617) 493-8319, (E-mail: chess@husc7.harvard.edu).
The Role of Banks in the Development of Small and Medium-size Enterprises
April 26-27, 1996, Krakow, Poland

The conference will focus on factors that hinder the development of small and medium-size enterprises in post-communist countries. Methods of financing this development will be discussed by bankers, researchers, and other conference participants.

Information: Prof. Jan Jerschina, the Jagiellonian University, Grodzka, 52 st. Krakow, Poland, tel./fax: (012) 375438, (E-mail: ussurde@cyf-kr.edu.pl).

Institutional Changes and Problems of Economic Adjustment
September 12-14, 1996, Grenoble, France

The European Association for Comparative Economic Studies will hold its fourth conference in cooperation with ROSES at the University of Grenoble II, France. Abstracts addressing the following topics are invited:

- macroeconomic modeling of the transition, evolutionist and institutionalist approaches, theories of corporate governance, organization and property rights, network economics, post-Keynesian theory of the state, theory of economic integration, gravity models, endogenous growth, and theories of regulation. Abstracts may be sent to: Xavier Richet, ROSES, University of Paris I, 90, rue de Tolbiac, 75634 Paris 13, France, tel. (331) 4077-1848, fax (331) 4584-7889, (E-mail: richet@lendit.univ.paris3.fr).

New Books and Working Papers

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

World Bank Publications

To receive ordering and price information for publications of the World Bank, write: World Bank, P.O. Box 7247-8619, Philadelphia, PA 19170, USA, tel. (202) 473-1155, fax (202) 676-0581; or visit the World Bank bookstores, in the United States, 701-18th Street, N.W., Washington, D.C. or in France, 66 avenue d'Iena, 75116, Paris, (E-mail: books@worldbank.org) (Internet: http://www.worldbank.org/).

Discussion Papers:


The Hungarian economy is emerging from a severe four-year recession with positive developments on numerous economic fronts, but with major weaknesses remaining because of large current account and fiscal deficits. Policy-makers have to stabilize the economy, and balance the fiscal and current account, without hampering economic growth. Long-term, overdue structural reform should embrace both the welfare system—pensions, health, education, family benefits—and the tax system, as well as the public sector, including the administration. Healthy growth, a streamlined economic structure, and a modern legal framework could pave Hungary's way toward European integration.

Country Studies


Recurring inflationary pressure on the Chinese economy has been caused primarily by funding the consolidated government deficit through increased borrowing from the central bank (over the past five years, this borrowing has financed more than two-thirds of the deficit). Local government-led surges in investment demand have been another major factor in generating inflation. If China wants a high, sustained growth rate and successful reforms, it has to reduce the central bank's role in financing the consolidated deficit, and it must promote greater economic decentralization, suggests the country study.


This annual cornucopia of international statistics—organized under three themes: people, economy, and environment—shows that between 1985 and
1994, China's economic growth was the third highest in the world, with 6.9 percent (in a tie with Singapore), surpassed only by Thailand (8.2 percent) and South Korea (7.8 percent). Many countries achieving high economic growth rates also have high levels of literacy, reflecting the link between basic education and growth. The Atlas shows that Botswana, China, Indonesia, Korea, and Singapore, all with economic growth rates of more than 6 percent in the past decade, have 96 percent or more of their primary-age children enrolled in school.


The report describes the experiences of countries that have privatized their state-owned enterprises with the assistance of the International Finance Corporation (IFC), the private sector arm of the World Bank Group.


Economic features of the individual countries, current socioeconomic issues, medium-term prospects, and development strategies. Regional Extracts: Volume 1, Eastern Europe and Central Asia (covering 23 economies) Volume 2, Emerging Capital Markets (covering 22 developing countries where stock markets and foreign investment has grown rapidly since the 1980s).

IMF Working Papers


In contrast to experience in Latin America, foreign direct investment in Central and Eastern Europe has increased significantly as a result of capital inflows in the transition economies. But this stream of FDI has not spurred higher investment ratios; rather, those ratios have fallen, while consumption, as a share of GDP, has increased throughout the region. [Substantial GDP decline throughout the region must also be considered. The editor.] To the extent that capital inflows are financing temporary increases in consumption—and causing real appreciation of the currency, as well as real wages, to overshoot—the inflows may need to be discouraged. "Second best policies" to stem expenditures in the private sector, such as imposing capital controls, levying taxes, and raising interest rates on government debt, have their drawbacks too.


CERGE-EI Working Papers, Prague

To order: Ms. Lucie Coxova, CERGE-EI Library, P.O. Box 882 Politickych veznu 7, 111 21 Prague 1, Czech Republic, tel. (422) 240-05186, fax (422) 242-11374.


Jan Svejnar, Katherine Terrell, Daniel Munich, and Mário Strapec, Explaining Unemployment Dynamics in the Czech and Slovak Republics, WP no. 60, April 1994.


Ales Cerny and Stepána Lazarová, Growth and Business Cycles in Czechoslovakia According to the Basic Neoclassical RBC Model, WP no. 65, April 1994.


Unemployment control and wage regulation, bankruptcy prevention, social safety nets, and active labor market
policies, although inconsistent with the Thatcherite rhetoric of the government, form the backbone of its popular support. The skillful implementation of the privatization program has also contributed to the government’s popularity.


CED Working Papers, Bratislava

To order: Center for Economic Development (CED), ELITA, Economicá Literárná Agentúra, VYDAVATELESTIVO a DISTRIBUTIJA Klinevá ul. c. 35 821 08 Bratislava, tel. (427) 526-1797, fax (427) 21-1388.


Large investors are exposed to strong political pressures, from both national governments and local authorities, as well as from different interest groups. Independent supervision over the capital market helps to create a competitive environment, which in turn prevents information misuse and tax fraud. Strong capital markets foster economic growth and efficient resource allocation.


CEPR Discussion Papers, London

To order: Centre for Economic Policy Research, 25-28 Old Burlington Street, London W1X 1LB, United King-
dom, tel. (44171) 878-2900, fax (44171) 878-2999.


The Czech Republic is the only country in the region to have gone through radical transformation without experiencing mass unemployment. Active labor employment policies played a major role in this unique situation: unemployment insurance was severely tightened (halving the duration of benefits, reducing eligibility), while subsidies for private sector employment and public work schemes were implemented on a large scale.

Property Foundation Working Papers, Budapest

To order: Property Foundation, Institute for Privatization Studies, H-1387 Budapest, Box 44, 18, Gyori ut, 1123 Budapest, Hungary, tel. (361) 202-5175, fax (361) 202-1093.


Princeton University Press Publications, Princeton

To order: Princeton University Press, 41 William Street, Princeton, NJ 08540, United States, tel. (609) 258-5714, fax (609) 258-1335.


Center for the Study of Public Policy Working Papers, Glasgow

To order: Centre for the Study of Public Policy, University of Strathclyde, Livingstone Tower, 26 Richmond Street, Glasgow G1 1XH, Scotland, tel. (0141) 552-4400, fax (0141) 552-4711.


Russian privatization was marked by the strategic decision in 1993 to corporatize large and medium-size factories by formally converting them into joint-stock companies prior to their restructuring. Their ownership was diversified via a massive subscription of factory shares by the public, in exchange for vouchers. By contrast, small assets in the trade and service sectors were sold or auctioned, or were leased (with prospects for their ultimate purchase). The quick corporatization of a large number of factories and the speedy sale of small assets to private owners were momentous achievements. The next phase: selling publicly owned shares on the stock exchange; and offering the new issues of stock for cash, which could generate needed capital from both foreign and domestic investors.

By contrast, Hungarian and Polish programs lacked a coherent strategy and a decisive drive, and lost at least three years in failed attempts to sell inviable factories to domestic and foreign investors. They also lacked the populist appeal of the massive voucher-based asset ownership that the Russian and Czech programs offered at the very start of the privatization agenda.


Marinko Papuga, Capital Market Development in Croatia, IRMO no. 16, September 1995, 25 p. To order: IRMO, Ulica Ljudevita Farkasa Vukotinovica 2, P.O. Box 303, 10 000 Zagreb, Croatia, tel. (38501) 4554-522, fax (38501) 444-059.


New Books


To order: Harvard Business School Press, Soldiers Field Road, Boston, MA 02163, USA, tel. (617) 495-6117 or (800) 545-7685.


In five years, the highly centralized and completely state-owned Czech economy have been transformed into one governed by market principles and private ownership. While favorable initial conditions have undoubtedly helped, many of the positive results, such as the low unemployment rate, rapid privatization, and continuous popular support for the transition, have been brought about in part by judicious government policies. There is no doubt that the Czech Republic provides an important case study for analysts and policymakers interested in understanding the complex process of transition. To order: Academic Press Limited, 24-28 Oval Road, London NW1 7DX, UK.

Newsletters and Special Publications

C.E.E.P.N. Newsletter, the newsletter of the Central and Eastern European Privatization Network. To order: CEEPN, Dunajska 104, P.O. Box 18, 61109 Ljubljana, Slovenia, tel. (38661) 1683-396, fax (38661) 346-660.


The Free Market, newsletter of the Lithuanian Free Market Institute. To order: Birutes 56, 2600 Vilnius, Lithuania, tel. (3702) 352-584, fax (3702) 351-279.

The Privatization Newsletter of the Czech Republic and Slovakia. Issue no. 33/34, April-May 1995, includes Foreign Direct Investment and Privatization, by Vladimir Benácek and Alena Zemplinerová. To order: Institute for Economics (IES), Smetanovo na 6, 110 00 Prague 1, Czech Republic, fax (3702) 351-279.

The Vietnam Business Journal, published by VIAM Communications Group Inc. To order: VIAM Communications, 381 Park Avenue South, Suite 919, New York, NY 10016, USA, tel. (212) 725-1717, fax (212) 725-8160.

Transition Brief, a new newsletter of the Centre for Cooperation with Economies in Transition. The first issue includes Salvatore Zecchini’s article on Perspectives on Economic Transition. To order: Centre for Cooperation with the Economies in Transition, OECD, 2 rue Andre-Pascal, 75775 Paris Cedex 16, France, fax (331) 4524-1843.

Journal of Policy Reform, a new journal from Harwood Academic Publishers, starting in early 1996. Editors: Arvind Panagariya, University of Maryland, Center for International Economics, College Park, MD 20742-7211, USA, tel. (301) 405-3546, fax (301) 405-7835, (E-mail: JPR@ECON.UMD.EDU), and Dani Rodrik, Columbia University. The journal analyses the successes and failures of countries undertaking reforms. Papers in the first two issues include G. A. Calvo and F. Coricelli, "The Political Economy of Delayed Reform"; A. Drazen, "Monetary Policy and Interenterprise Arrears in Post-Communist Economies"; R. B. Fernandez and P. E. Guidotti, "Exploring Interactions Between Capital and Reserve Requirements" [in transition economies]; Y. Qian and B. R. Weingast, "Market Preserving Federalism, Chinese Style." To order: International Publishers Distributor, c/o PO Box 90, Reading, Berkshire, RG1 8JL, UK, Tel: (44-1734) 560-080 Fax: (44-1734) 568-211.

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Bibliography of Selected Articles

**Postsocialist Economies**


China


Drumm, L. Note: Changing Money: Foreign Exchange Reform in the


CIS and the Baltics


Viet Nam

